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DEPARTMENT OF STATE

WASHINGTON, D.C. 20520

TO: Members of Alternative Energy Group

FROM: C - James L. Buckley

SUBJECT: Meeting of the Alternative Energy Group  
October 7, 1982, at 2:30 p.m.

Attached are materials for the forthcoming meeting of the Alternative Energy Group. The meeting will focus on the first paper, Energy Alternatives for Western Europe: Overview of International Measures. At tabs following the overview paper are background materials prepared by the CIA and the State Department.

Attachment

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Energy Alternatives for Western Europe  
Overview of International Measures

Introduction

Looking ahead, a variety of energy alternatives are available to Western European countries now committed to or considering the purchase of Soviet gas. Most of these alternatives involve substantial leadtimes and may result in nominal energy costs in excess of those offered by the Soviets. The task the U.S. now faces is to find ways to ensure that Europe chooses these energy alternatives rather than increasing its dependence on Soviet gas.

In Europe, Ambassador Galbraith has been working to encourage commercial agreement to develop energy alternatives, particularly the massive 31/2 gas field in Norway. The U.S. should now consider what foreign policy measures could assist in achieving this objective. A preliminary list of potential international measures is presented here in skeletal form. Further work will be needed on those initiatives that have particular merit.

Demand-side Commitments

A first step in any effort to promote alternatives to Soviet energy dependence must be to prevent any further commitments to Soviet gas. The rapidly changing energy market outlook makes such commitments particularly timely.

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Over the past two years demand for natural gas, one of the fastest growing fuels in Europe in the 1970s, has been weakening, as a result of the recession, sharply higher gas prices, and the falling real price of oil.

In this uncertain situation the Soviets could preempt the market for the development of Western energy resources by a combination of predatory pricing on spot sales of gas (utilizing excess pipeline capacity), and the temptation of another gas pipeline mega-project -- the so-called "second strand" pipeline.

The Soviets are already disrupting European gas markets with highly unusual spot sales (3 to 12-month contracts) utilizing excess pipeline capacity. With the completion of the "Yamal" pipeline in the mid-to-late 1980's their capacity to do so would be significantly increased.

A coordinated counter-strategy is required. To create the conditions where commercial negotiations can take place for the development and sale of alternatives to Soviet gas, we would ask the principal European gas-consuming nations to not commit to any incremental deliveries of Soviet gas beyond the amounts currently contracted. This would reserve for Norway and other potential suppliers a sufficiently large market share to enable them to develop the gas required to meet Western Europe's expanding needs. This would also foreclose the possibility of proceeding with a second Soviet line.

The Europeans could put even more pressure on the Soviets if they would agree to make full use of the downward

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offtake flexibility in current Soviet gas supply contracts. Under current contracts gas purchasers can reduce their take by as much as 20 percent in a given year. A dedicated European effort to make the Soviets bear the brunt of demand shortfalls (a role now becoming uncomfortable for the Dutch) would significantly reduce the political leverage the Soviets may believe they have acquired as a result of the pipeline deal.

#### Accelerated Development of Alternatives

The main sources of alternative energy for Europe are well known--Norway, Holland, U.S. coal, Algeria, Nigeria, the Middle East (Iran, Qatar) and other LNG suppliers--but significant obstacles must be overcome in each case before competitive energy supplies can be offered to European markets. British energy policy developments may also affect the gas supply balance, if not through the direct export of UK-sector gas to the Continent, then by the volume of gas the UK imports from Norway.

Accompanying papers analyze the economics of supply and the obstacles that apply to the development of significant energy alternatives in each of these countries and the U.S. To a greater or lesser degree, however, all alternative sources face the following problems.

a. Economics: The Soviets can supply incremental gas to Western Europe very competitively. With low construction costs, no right-of-way acquisition costs, subsidized credit available for equipment imports, considerable infrastructure

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already in place, few environmental constraints, and a government decision-making apparatus facing no domestic opposition to pricing gas from a new pipeline at sub-market rates, the Soviets have significant economic advantages. On economic grounds, however, the unit price of Soviet gas to West Europe is understated in that it does not include the cost of interest rate subsidies nor the cost of needed gas security measures. The IEA's Gas Security Study, scheduled for completion in Spring 1983, will permit us to calculate the "true" price of Soviet gas. This is crucial to determining the level of any "security premium" to be assigned to the price of Norwegian gas.

Norway's gas reserves are contained in large deposits not particularly distant from European markets, but the water is deep and the technology will be state-of-the-art. Access to investment capital is no problem, but prospective borrowers must pay commercial interest rates. Algeria is close to Europe's market, but it is facing technical gas extraction problems that might limit the ability to supply additional demand, even if prices were set on an economic (rather than political) basis.

Extensive planning and feasibility studies have assessed the potential of Nigerian gas, shipped by LNG tanker to European markets. The latest project proposal is expected to be completed in the coming months, and is said to show Nigerian gas can be competitive with Norwegian or Algerian

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supplies, but not with the base price for Soviet gas. The economics of other potential suppliers are uncertain. Feasibility studies are planned or underway in Iran, Qatar and Cameroon.

b. Politics: In Norway there has been concern that the rate of hydrocarbon developments is too fast, or that oil and gas earnings may damage the economy. Also, political interests keep tax and national ownership requirements high, reducing the incentive for development by international oil companies. In Holland, a conservative gas depletion policy has been in effect, in order to save Dutch gas for domestic needs in the 21st century.

In Algeria and Nigeria the political objective of crude oil parity pricing has wide support. Iran's present regime has a deserved reputation for instability, and Iranian advocates of large export projects to the West face the constant risk of attack by radicals.

In the UK political pressure keeps prices for residential use of natural gas for below market levels, even though a program of periodic adjustments has been in train for two years. Low producer prices and high tax rates prevent exploitation of marginal fields and encourage wasteful use of gas in the domestic market.

There are, however, some encouraging political signs. Norwegians are increasingly concerned about their commercial interests and the threat of Soviet takeover of the market; the Dutch need more revenue; Nigeria is in difficult economic

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straits and needs LNG earnings; Algeria was perhaps more flexible on price in its recent contract with Italy; and the UK is continuing its effort to return its gas industry to the private sector.

c. Technical Factors: Norwegian sector gas from the Troll field cannot be on stream until the early 1990's. Even then the existence of a large but shallow oil deposit under the field will limit early year gas production. Gas deposits in the far North (Tromsa) will be difficult to produce, given the distances to potential markets, and the environmental hazards.

LNG plants in several countries have experienced unexpected technical problems which have increased costs and caused supply disruptions. Algeria has had such problems at its Mediterranean loading facility at Arzew.

#### Potential International Measures

Some of the foregoing obstacles can be reduced with U.S. assistance, and some cannot. The following is a list of potential U.S. actions in support of international energy alternatives that have been suggested in various quarters. Not all are feasible or politically acceptable, and all will require further study.

#### Demand-Side Measures

a. Ask the European countries involved in the current Soviet pipeline project for explicit assurances not to commit to any incremental deliveries of Soviet gas beyond the

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amounts currently contracted, and to make maximum use of downward offtake flexibility in current contracts.

b. Support study designed to quantify the true cost of Soviet gas on a unit basis, conducted by reputable outside consulting firm. Utilize analysis of IEA Natural Gas Security Study now under preparation. Provide as much USG information to analysts and IEA as possible. Widely disseminate results to European governments and publics. (See paper at Tab J.)

Supply-Side Measures

1. Norwegian gas, particularly development of 31/2 field.

a. Study U.S., UK and Norwegian corporate income tax regimes to determine the impact on the pace of exploration and commercial price for gas produced. If appropriate, propose special development incentives or other modifications to accelerate development.

b. Examine other Dutch, Norwegian and British policies affecting exploration and development to see if economic analysis would support modification of these policies allowing greater medium-term gas production. Factor in revised forecasts for oil prices.

c. Encourage Norway-Netherlands gas supply cooperation, with particular attention on Norwegians who up to now have preferred to maintain their autonomy. Invite Dutch energy experts to visit Washington for interagency consultations similar to the Ramm visit. Perhaps undertake low-key high level Mission to Norway in November.

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d. Mount a major effort to get the IEA focussed on the May 1982 Ministerial commitment to "develop indigenous sources of gas". Press for special attention to this problem and the scope for cooperative action within the IEA's Standing Group on Long-Term Cooperation.

e. NATO-wide agreement to subsidize Norwegian gas development (perhaps 31/2) in light of its security significance. Agreement could take form of contingent burden-shared commitment to split difference between commercial cost of Norwegian gas and Soviet gas price plus externalities (i.e. security costs). One possibility would be to use the Defense Production Act to cover the U.S. portion of any such arrangement.

f. Invite key oil companies and investment bankers to Washington for high-level consultations on energy alternatives available to Western Europe.

g. Provide domestic benefits to U.S.-based oil companies as trade-offs for agreement to accelerate work in North Sea, or accept lower than average returns. Trade-offs could include preferential access to offshore acreage in the U.S. and or deferral of bonus payments.

h. Encourage U.S. companies to approach the Norwegians with offers to purchase LNG from a Tromsa liquefaction facility, thereby accelerating Norwegian plans to undertake such a project and assisting Norway in diversifying its export markets. (See CIA paper on this idea Tab K).

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2. Coal

a. Sponsor special R&D program to tackle technical objections (environmental and transport) impeding penetration of coal in European power and industrial sectors. Finance technical studies of specific coal utilization sites.

b. In return for U.S. measures to expedite long-term coal exports, ask European governments to adopt specific measures to increase coal use, such as continuing development of their coal supply infrastructure, and re-examining environmental regulations and domestic mining industry supports to ensure they do not levy burdens on coal consumers. (See list of potential measures at Tab I.)

3. Other Gas

a. Urge Nigerians to accelerate preparation of a "Bonny II" gas exploitation scheme by showing how the window of market opportunity is closing. Support World Bank and Ex-Im Bank financial assistance for Nigerian gas development capital costs. Consider a favorable response to the Nigerian request for a finding by the Comptroller of the Currency that U.S. bank loans to an LNG project consortium would not be subject to country lending limits.

b. Inform Europeans of quiet U.S. moral support for Iranian gas export scheme, although maintain a non-committal public posture.

c. Consult with Saudis on Persian Gulf gas export schemes, with particular concentration on financing needs.

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Talking Points for Case I

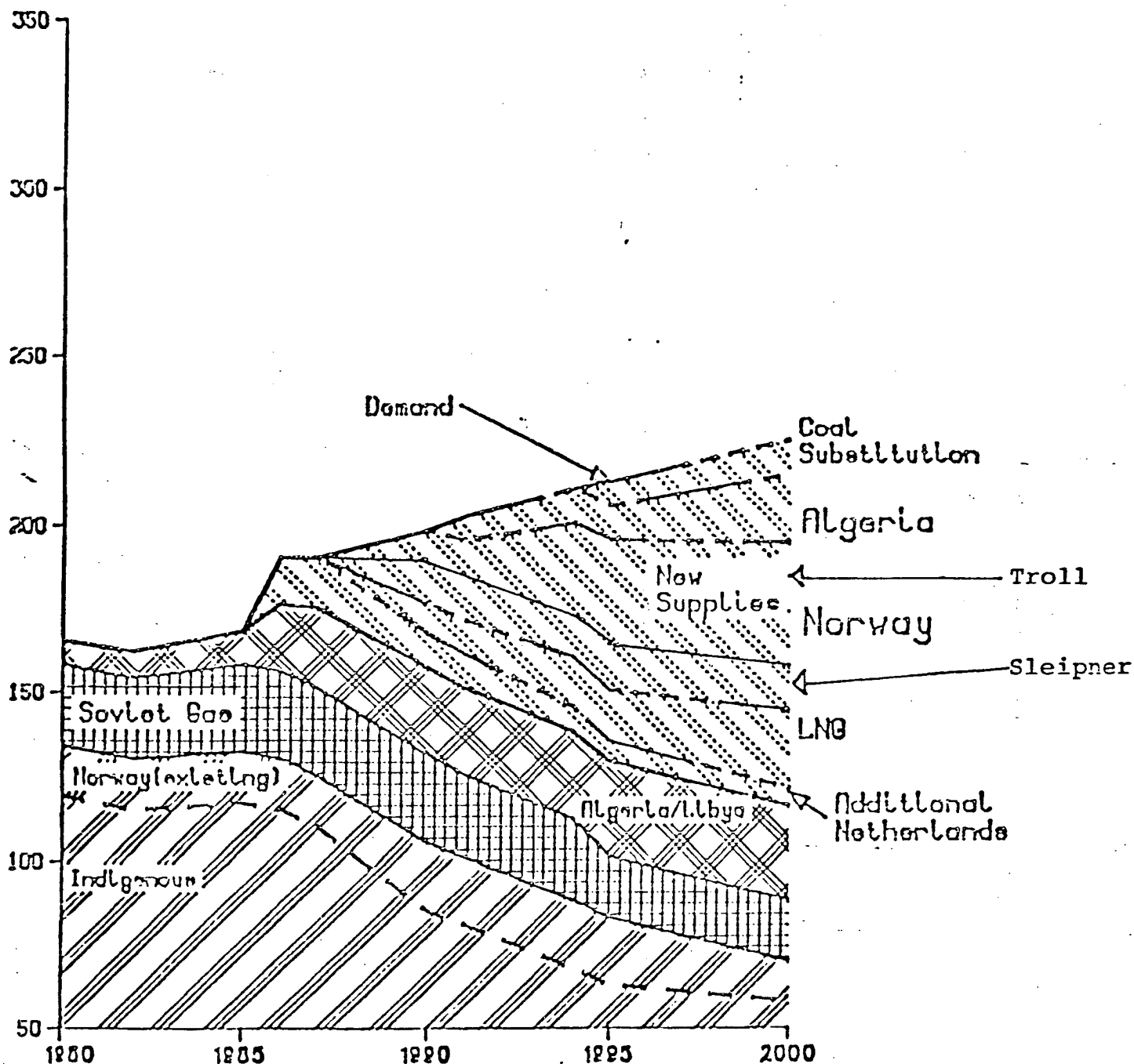
## (European Gas Supplies without Siberian Gas)

- o This graph shows declining indigenous production particularly after 1985 as West European gas supplies are depleted or shut in.
  - By 1990, indigenous production would approximate 85 billion cubic meters (bcm), falling to almost 58 bcm by the year 2000.
  - Existing Norwegian production is then shown at about 20 bcm in 1990, falling to 12 bcm by 2000.
  - Existing Soviet production follows at 26 bcm in 1990 and 18 bcm by 2000.
  - North African gas will provide approximately 26 bcm in both 1990 and 2000.
- o A supply shortfall begins to emerge after 1985 increasing thereafter by considerable proportions as potential supplies fail to meet projected demand. With demand at 200 bcm, the shortfall will be about 43 bcm in 1990. The gap widens to 112 bcm in 2000 when demand reaches 226 bcm.
- o Without Siberian gas, Norwegian gas coupled with Algerian gas, US coal, some LNG and a slower rate of the phase out of Dutch exports could theoretically balance supply and demand. However, the economic and political decisions necessary to bring about this combination of events would require a major reversal of existing policies within the next few years, which does not appear likely.
  - Norway is reluctant to speed up development because of concerns over the impact it would have on the domestic economy. Consumers may be unwilling to pay the high prices demanded by the Norwegians for new gas contracts. In addition, private companies may be unable to finance major gas development projects.
  - Algeria's militant pricing policy and its unilateral suspension of gas deliveries to France and the United States in 1980 make it a high-priced and potentially unreliable supplier.

- The US can provide some additional coal by 1990 but volumes are likely to be small. Western Europe already has ambitious plans to use coal and would need to expand coal hauling capabilities even further. Some type of subsidy would probably be needed to encourage greater industrial coal use.
- LNG from North Africa or other sources would be very costly.
- Without a change in the current conservation policies of the Hague, the amount of Dutch gas available for export in the late 1990s will dwindle to less than one-fourth its present volume.

# Continental Europe: Natural Gas Supply and Demand Forecast 1980-2000

BILLION CUBIC  
METERS PER YEAR



Low Demand Scenario  
Without Siberian Gas

Talking Points for Case II

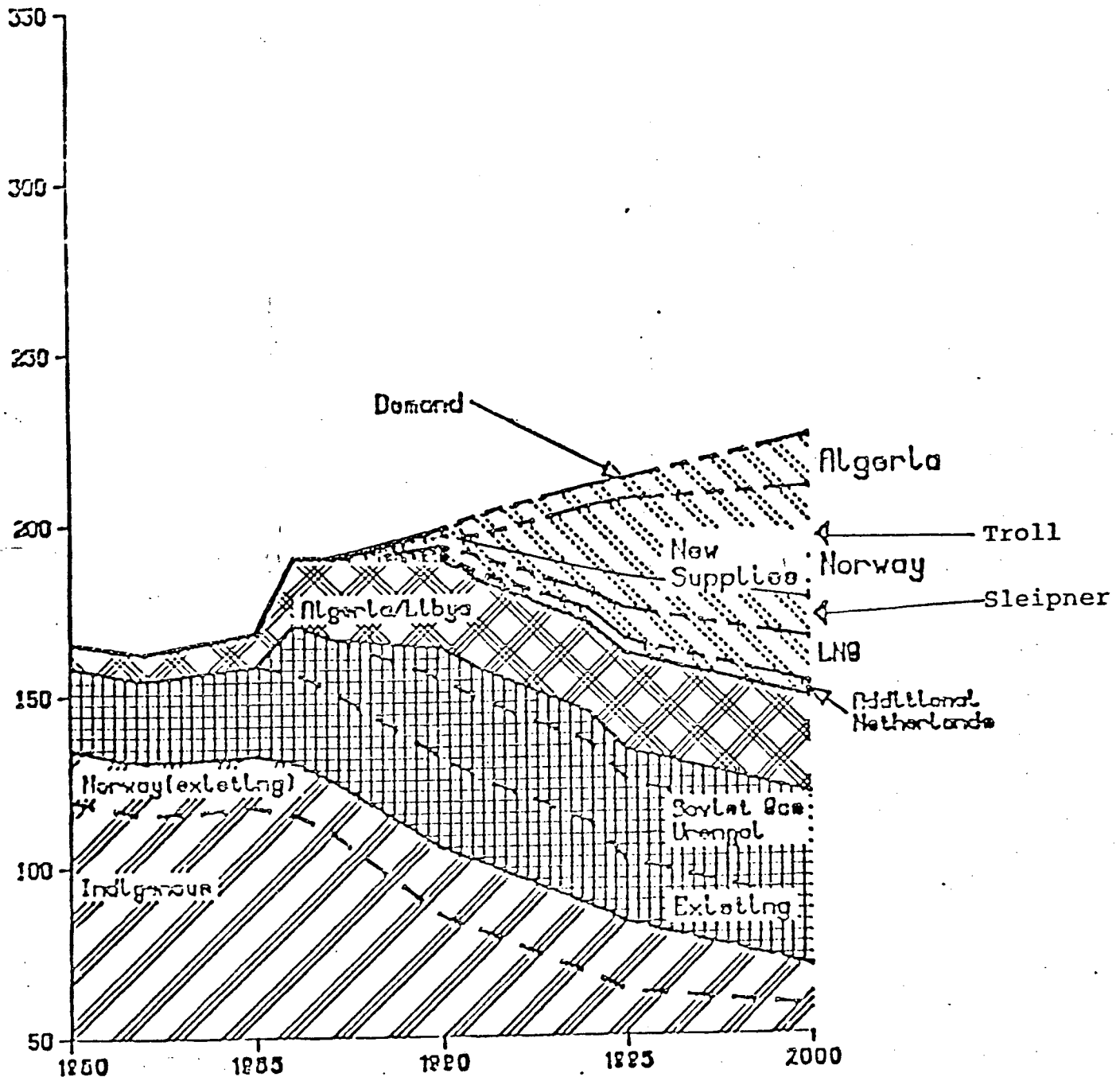
(European Gas Supplies with Siberian Gas, only One Strand)

- o This graph assumes that the Siberian pipeline is completed and that no new gas contracts beyond those presently being contemplated are agreed to.
- o Siberian gas purchases will probably provide 23 bcm (minimum) or 32 bcm (maximum) in both 1990 and 2000, supplementing existing Soviet gas supplies which will steadily decline from about 26 bcm in 1990 to almost 18 bcm in 2000.
- o Although Siberian gas will not eliminate the prospect of a supply shortfall which will likely occur in the late 1980s, it will minimize the potential magnitude of the shortfall. Assuming minimum purchases of Siberian gas, the shortfall is likely to be about 32 bcm in 1990 and 63 bcm in 2000. With maximum purchases the shortfall would probably approximate 23 bcm in 1990 and 80 bcm in 2000.
- o In this case, substantial volumes of additional gas from Norway and Algeria will not be needed until the mid 1990s. This cushion could provide the Norwegians the lead time required to bring major gas projects on line.



# Continental Europe: Natural Gas Supply and Demand Forecast 1980-2000

BILLION CUBIC  
METERS PER YEAR



Low Demand Scenario

Talking Points for Case III

(Maximum Soviet Share, One Strand and use of Existing Capacity)

- o Completion of the Siberian pipeline to the Czechoslovak border will add approximately 29 bcm of capacity to the probable current Soviet export capacity of 56-60 bcm, bringing the system's total export capacity to 85-89 bcm. After accounting for gas sales to East Germany and Western Europe including 20 bcm of Siberian gas, excess capacity of the Soviet-Czech system would total 22-26 bcm. If Italy decides to purchase 6-8 bcm of Siberian gas, the system's total excess capacity will drop to 16-18 bcm by 1990.
- o Expansion of the Czech domestic network in addition to the 29 bcm Siberian pipeline capacity would yield an excess capacity in the Czech system of about 11-13 bcm. (Italy's purchase of 6-8 bcm is factored into this calculation.)
- o With projected excess capacity on the order of 16-18 bcm, the Soviets could effectively capture an even larger share of the West European gas market in the 1990s. The Soviets could:
  - delay development of Norway's Sleipner field which in turn could reduce the market for Troll gas to about 20-25 bcm. A reduction in the market for Troll gas could render field development uneconomical.
  - or eliminate any North African projects such as Algerian gas, Nigerian or Cameroonian LNG.

USSR-Czechoslovakia: Gas Pipelines and Exports to the West

(Billions of Cubic Meters per Year)

<u>Present Status:</u>	<u>Soviet- Czech System</u>	<u>Czech Domestic Network</u>
Effective Capacity:	56-60	43
to East Germany	N.A.	7
to Western Europe	N.A.	36
Sales/Throughput:	43	26
Excess Capacity:	13-17	10
<u>Planned Additions:</u>		
Export Pipeline - Siberia to Western Europe	29	29 <sup>a</sup>
Contracted Sales/Throughput	20	20
Excess Capacity:	9	9
<u>Total Excess Capacity:</u>	22-26	19

N.A. - Not Applicable.

a - Assumes Czech domestic network is expanded to handle increased Soviet export volumes.

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NORWAYEconomics

Norway currently supplies Europe with 27 bcm of gas, 11 bcm to Britain by way of the Frigg pipeline system and 16 bcm to Germany by pipeline from Ekofisk. The Ekofisk gas is priced at \$4.25 per million btu (mmbtu) c.i.f. Emden, and is competitive with Dutch and Soviet alternatives. A new "Statpipe" system will bring additional gas from northern fields to fill in the Ekofisk line's excess capacity (some 8 bcm/yr.), but the price for this gas, \$5.50 mmbtu, is high. This has led Belgian, German and French gas consuming companies to grumble about withdrawing from commitments to purchase Statpipe gas, but 30 year supply contracts were signed without incident in September 1982.

Norway has huge gas reserves, but production and transportation costs are high. One of the largest fields in the world is the "Troll" structure in block 31/2. For Troll, a tie-in to the Frigg line to the U.K. is the least-cost development option, but even with additional compression Frigg could deliver only 26 bcm/yr. to the U.K., considerably less than the field is expected to be capable of producing. A truckline to the continent to carry 38 bcm/yr. would entail capital costs of more than \$3 billion and take two to three years longer than the Frigg option. Gas from the Sleipner field could be available sooner, but the fractured geological structure will require at least five production platforms, and the high CO<sub>2</sub> content of Sleipner gas will raise development costs and limit transportation options.

In May a Special National Intelligence Estimate concluded that large additional supplies of Norwegian gas would probably cost 15 to 20 percent more than Soviet gas if no interest rate subsidies were offered for the Norwegian project. Nevertheless, there is definite commercial interest in Troll and Sleipner development, indicating that producers and consumers alike see this gas as potentially marketable in the early 1990's. Shell, operator of Troll, is moving ahead on a development plan and is expected to declare the field commercial in early 1983. It has commissioned six feasibility studies on development alternatives. Sleipner also is the subject of a full testing program and its operators, Statoil, Norsk Hydro and Esso began negotiations with 20 potential buyers in August-September, and propose a development plan to the GON in early 1983.

Obstacles

The principal obstacles to Norwegian gas development are price competition from the Soviet Union and potential political concerns in Norway, Holland and the U.K.

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Soviet price competition is likely to be the most serious obstacle. The Soviets put a high value on hard currency, and in Siberia they have massive onshore gas reserves which are still untapped. Once the first pipeline is completed, a "second strand" line could be built at a considerably lower capital cost. Moreover, even without a second line, the Soviets could try to undersell Western alternatives with gas allocated from its existing pipeline grid. The net result is that the Soviets will have a continuing cost advantage over new Norwegian gas which they are likely to exploit.

Political obstacles to Norwegian development are still hypothetical in advance of commercial development plans, but several problem areas can be foreseen. For example, there have been recent indications that Norway would rather have direct export lines to European markets, rather than using the U.K. as a "land-bridge" to Holland or France. (In a policy shift, the U.K. has recently expressed its amenability on a direct pipeline deal, however). Norwegian insistence on a direct pipeline would delay development, and increase the cost of the gas.

A potential technical problem is the program for exploitation of the oil associated with the Troll field. The Norwegian government could require full extraction of the thin layer of oil before allowing gas production to begin (the technically optimum solution). A final long-range constraint is Norway's legislative requirement that hydrocarbon production in the 1990's not exceed 90 mtoe (Metric tons of oil equivalent), in order to protect the domestic economy. However, the GON is reconsidering the whole subject of production ceilings, and under current plans the 90 mtoe ceiling would not be reached until after 2000, even with Troll development.

NETHERLANDSEconomics

The Netherlands is currently Europe's largest and lowest-cost gas supplier. Dutch production in 1981 totalled 82.7 bcm, although exports were down 9.9% and domestic consumption was off 4.8%. Despite over twenty years of production, the official Dutch estimate of proven gas reserves is 2.1 trillion cubic meters (TCM). Well-informed industry sources believe reserves are considerably higher. The bulk of Dutch gas reserves are found in the onshore Groningen field, an extremely large field with unusual geological characteristics that allow for great flexibility in production. The current Dutch export price is \$4.45 mmbtu at the border.

In the sixties, the Dutch sought to increase gas exports and maximize gas use in the Netherlands. Following the OAPC oil embargo against it in 1973 Dutch policy shifted, in part in order to "conserve" hydrocarbon assets for future generations, and in part to limit growth in public revenue that funded generous public services. Accordingly, during the late 1970's the Netherlands informed its customers that it would not be renewing gas export contracts as they expired between 1985-95, a decision which prompted European gas importers to look elsewhere (including the Soviet Union) for gas.

Recently, the recession and contract offtake flexibility have resulted in significant reductions in domestic and (especially) export sales. With attendant losses in government revenue, the Dutch have begun to rethink their conservationist policies. Commercially, they see their gas export markets going to other suppliers (the Soviets and Norwegians) and with oil price weakness there is some political sentiment that keeping gas in the ground for future generations may not be sound economic planning. Financially, the government needs the revenue.

Unfortunately, one response to this financial bind has been a 15% price cut in gas sold domestically for power generation, in exchange for utility agreement to take an extra 4 bcm/yr. of gas for the period 1982-87. This short-sighted policy not only will use gas which might otherwise be available for export, but may reduce the incentive to build coal-fired electricity generation facilities. Even so, the Dutch were willing recently to "guarantee" to 1995 any residual Belgian gas needs so as to allow them refuse Soviet gas.

Obstacles

The Netherlands clearly has the gas reserves to continue to supply European export markets into the mid-1990's and, many observers believe that a more development-oriented tax and leasing policy would lead to significant additional discoveries off-shore. The major obstacles are political, and transcend normal party lines. In the dispute Dutch Socialists concerned with protecting welfare funds from further cuts are allied with development-oriented conservatives. Fiscal conservatives interested in limiting growth of government spending oppose an increased production rate, and environmentalists are interested in preserving clean-burning gas for domestic needs. One problem is the now firmly ingrained public perception of the growing scarcity of gas reserves.

Ambassador Dyess has reported that the balance is shifting in favor of the exploitationists (as also evidenced by the help recently given to Belgium) but has warned against incautious and counter-productive U.S. moves. Nevertheless, it would be politically difficult for the Dutch to move completely to an all-out development and export policy. It has been already evident in discussions with the Belgians that the GON fears that partial reversal of its export phase-out policy in favor of one customer would lead to similar requests from all of its EC partners.

UNITED KINGDOMEconomics

The U.K. is largely self-sufficient in natural gas, and, compared to continental Europe, consumes a greater proportion in the residential and commercial sectors. Over 77 percent of consumption is supplied from natural gas production in the British sector of the North Sea, a large part of which is associated gas. The U.K. imports modest quantities of gas from Norway (via the Frigg system which also transports gas from the U.K. sector) and small quantities of LNG from Algeria for peak shaving purposes.

Domestic U.K. production has suffered from significant disincentives. First, the British Gas Corporation (BGC), a State entity, had monopsony power over all gas produced in the U.K. sector. Second, frequent changes in tax regimes and high marginal tax rates discouraged all hydrocarbon development. And administrative and regulatory delays have inhibited decisions on economically viable gas-gathering systems. Recently, HMG took steps to return BGC to the private sector and amended the law to allow large industrial gas consumers to negotiate directly with gas producers. BGC still has a monopoly over the large and politically sensitive residential and commercial markets, however. Delivered prices are relatively low, but the government is implementing real annual price increases of 10% per year for three years.

The U.K. government, most oil companies and many private analysts expect the U.K. to remain roughly self-sufficient in gas over the coming two decades. A notable exception is Peter Odell, who believes that with proper production-oriented policies the U.K. could produce an exportable surplus by 1990. Recently the natural gas manager of Esso Europe told Embassy London that he expected that the U.K. could absorb all of the roughly 10 bcm/yr produced by Norway's Sleipner field, and still not have any domestic gas that could be exported to the Continent from the southern sector gas fields.

Obstacles

Integrating the U.K. into the West European gas supply grid and obtaining full potential gas production from its offshore fields is an economic, as well as political challenge. HMG has recently expressed its willingness to serve as a "land-bridge" for moving Norwegian gas from northern fields to the Continent. But the Norwegian government is opposed to linking its two primary markets in a way which would reduce its pricing flexibility, and potential British gas shortfalls limit the volume of Norwegian gas that would actually reach Continental consumers in any case. Another problem might arise in the negotiation of transit fees.



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And, even though the HMG currently expresses interest in the "land-bridge" concept, political opposition can be expected if and when a formal proposal is presented. Consumer groups will fear that the availability of continental markets for British gas will lead to higher retail prices, and conservatives will fear such a link would mean Britain would be forced to share in any European gas shortfall (such as that which might result from a Soviet cut-off).

ALGERIAEconomics

With 3.2 tcm of proved reserves, Algeria holds the world's fourth largest gas reserves. As its oil exports -- the traditional major source of foreign exchange earnings -- are depleted, gas exports are becoming increasingly important to Algeria. Algeria currently has contracts to export some 37 bcm in a combination of LNG and pipeline gas, mostly to Western European customers. Of that figure, 12.5 bcm is scheduled to be delivered through the \$3 billion Trans-Mediterranean pipeline to Italy, while 24.5 bcm of LNG is contracted to French, Belgian, and U.S. customers. However, Algeria is delivering less than the equivalent of 11 bcm per year at the current time because of a variety of problems, mostly involving its demands for price renegotiation.

Over these amounts, it is conceivable that Algeria could deliver an additional 20.5 bcm in pipeline gas and 6.6 bcm in LNG to Europe by the mid-1990's. Such a boost in pipeline deliveries would require the construction of additional compressor stations on the existing but currently unused Trans-Medline, enabling 5.5 bcm of new supplies while a pipeline via Morocco and across the Mediterranean to Spain (the so-called Segamo project) could deliver 15 bcm. In addition, there has previously been discussion of construction of a new pipeline (Trans-Med II) parallel to the existing Trans-Med line, but this idea has faded because of Algeria's continuing refusal to begin deliveries to Italy from the Trans-Med line without a gas price increase. Although technical difficulties have plagued the history of Algeria's LNG operations, theoretical LNG production capacity is 31.1 bcm per year. Thus, it is possible that 6.6 bcm of LNG beyond currently contracted levels might be available for Western Europe.

Obstacles

A new CIA analysis indicates that Algeria will be able to meet only half of its current gas export commitments to Western Europe and the United States for the remainder of the decade, let alone increase exports. The CIA study cites unanticipated production problems in developing existing gas fields, Algeria's inability to accelerate development of new fields, and rising domestic consumption as the key reasons behind its judgement.

Algeria's militant pricing policy and its unilateral suspension of gas deliveries to France and the United States, make it an unreliable supplier.

With an estimated CIF price in Europe of \$6.19 per MMBTU, Algerian gas would carry a heavy implicit "security" premium over Soviet gas, resulting in additional Western European gas costs of \$1.8-2.2 billion per year. Algeria has moderated its pricing demands somewhat in its recent agreement with Italy, but even so, the Italian Government must contribute a subsidy of \$0.40 per mmbtu to allow the gas to be marketed.

On the LNG side, technical problems have limited Algerian production to only a fraction of designed plant capacity, and it is very uncertain that Algeria could ever reach full capacity necessary for a large increase in exports to Western Europe.

Economics: Three gas delivery schemes -- one pipeline and two LNG -- to deliver Nigerian gas to Europe have been discussed in recent years. Under the first LNG project, Bonny LNG, Nigeria planned to provide gas supplies of 8.35 bcm per year to both the United States and Western European markets. It was cancelled in February 1982 as a result of a lack of a firm financial commitment by Nigeria, withdrawal of key foreign companies from the project, lower estimates of European gas demand, and Nigeria's insistence for gas prices at crude oil parity.

A second proposal, the Nigerian LNG project, was recently proposed by the Federal Republic of Nigeria as a more modest alternative to the defunct Bonny project. Estimated to cost some \$4.3 billion (1982 dollars) and capable of 9.3 bcm per year, it would begin in 1983 and be completed for gas shipments in 1988. Unlike Bonny, it is targeted at principally European markets (Germany, France, Italy and Great Britain) but with enough capacity to make possible sales to Japan and the U.S.

The Nigerian Government has hired U.S. legal, technical and financial consultants to assess the project and a preliminary feasibility report is scheduled to be available in December. Financial support would be sought from several sources, including private commercial banks, the World Bank, export credits (such as EXIM assistance) and some Nigerian Government funds.

The pipeline proposal would annually carry about 15 bcm of gas through North Africa to Western Europe. Three trans-Saharan routes for such a 2,250-2,600 mile pipeline have been considered, two of which transit Algeria. Although one preliminary industry estimate placed pipeline construction costs at \$10 billion, total costs would likely make the project financing requirements about equal to those of the Bonny LNG proposal. In spite of lobbying efforts by Algeria and domestic proponents, the Nigerian Government rejected the pipeline proposal in early 1981 after the Algerians refused Nigeria's request to retain total control over any pipeline transiting Algeria. Despite continued support from Nigerian politicians from northern states who would benefit from the pipeline and a Bechtel Corporation report in May noting that the pipeline was technically feasible, the Federal Government has stated that it is no longer considering the pipeline as an active option.

#### Obstacles

##### Nigerian LNG

-- A CIF price structure for LNG gas comparable to Algerian gas prices would constitute a "security" premium

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over Soviet gas of \$.79-\$1.49 per MMBTU and would cost European consumers an additional \$475-754 million per year. Thus, serious problems remain in pricing the gas to be competitive in the European fuels market.

-- As a result of declining oil revenues in the current soft world oil market, it is questionable that Nigeria has the foreign exchange necessary to finance its share of the project. Necessary initial Nigerian investment of \$10 billion would again be the subject of intense political debate, and would be an issue in the 1983 Presidential election.

-- The Nigerians would require generous export credit arrangements in addition to financial wherewithal to finance its share of the project. From the U.S., significant EXIM bank support and a decision by the U.S. Comptroller General that Nigeria credit ceilings to U.S. EXIM lending would probably be required.

#### Trans-Saharan Pipeline

-- The Federal Government of Nigeria is opposed to this option.

-- Fees charged by countries the pipeline would transit could be exorbitant. In the event that the most direct route -- through Algeria -- were chosen, Algeria would undoubtedly charge a high transit fee to ensure that Nigerian gas was not more favorably priced than Algerian gas competing for the Western European market.

-- Local and regional political instability makes the project a high-risk proposition.

-- Because of extreme water depth in the Gibraltar Straits, technical problems could be encountered in constructing the pipeline and repairs would be both expensive and unwieldy.

-- Shell and other foreign producers are unwilling to consider any Nigerian gas project until the mid-1980's when they will reevaluate the European gas market and the Nigerian political situation.

## CAMEROON

Economics: Segazcam -- a consortium comprised of the Cameroon state oil company (Societe Nationale des Hydrocarbours), U.S. companies Mobil and Pecten (Shell), and French companies Elf-Aquitaine and Total -- is studying the feasibility of constructing an LNG facility in the Kribi region of southern Cameroon. While the project was originally targeted to serve both the European and U.S. gas markets, Europe is now considered the likely importer for the full volume. The estimated cost of the project, including construction of a three train liquefaction plant, infrastructure, and LNG tankers, is around \$10 billion.

Although the consortium initially anticipated LNG production capacity of 6 bcm a year, a recently-released and long-awaited study on Cameroon gas reserves prepared by Franlab Consultants (Institut Francais du Petrole) indicates that the project reserves are only half of the level previously expected. With total Cameroon gas reserves now estimated in the neighborhood of 100 bcm, the consortium -- led by the Cameroon Government -- is reportedly reassessing the viability of the project. As an alternate to scuttling the project, the size of the proposed plant could be reduced from six to four bcm annual capacity. Consortium members are also reviewing projections of European gas demand; while start-up date was originally planned for 1987, European demand figures suggest a more distant timescale. A final decision on the fate of the project is not expected until the end of 1983.

Obstacles to development:

-- Smaller than anticipated Cameroon gas reserves may make the project uneconomic. Even if the project were completed as originally proposed, production might not be sufficient for Europeans to consider the project as an attractive alternative to Soviet gas.

-- Uncertain European gas demand clouds the viability of even small LNG volumes available for export.

-- Given probable cost overruns, relatively small scale of project, and inherently more expensive LNG form of gas to importer, gas price (now unknown) may not be competitive with pipeline alternatives.

-- Project would probably not be on-stream before early 1990's at the earliest and might not be able to meet European gas requirements in the late 1980's and early 1990's.

US Coal and the Siberian PipelineKey Judgments

US coal is one of the alternatives being investigated as a means of reducing or supplanting West European purchases of Soviet natural gas. We believe that there is little prospect for expanding West European coal use during the 1980s beyond that already planned. Indeed, our analysis indicates that West European coal consumption in 1990 may fall short of planned levels by as much as 950,000 b/doe. [REDACTED]

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Beyond 1990, however, considerable potential exists for expanding coal use in Western Europe. As growth in nuclear power slows and electricity demand picks up, much of the burden for generating electricity will fall on coal. In the industrial sector, the bulk of existing oil and gas-fired boilers will need replacing. If West European governments help industrialists overcome the considerable capital costs of switching, we believe coal could capture much of this market--saving an estimated 1.8 million b/doe of oil and gas by the year 2000. Combined with North Sea and Dutch gas supplies, expanded coal use could well obviate the need for additional purchases of Soviet gas in the 1990s. Soviet gas imports, therefore, could be limited to the 900,000 b/doe already contracted for during this period. [REDACTED]

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Increased coal use will not only enhance the energy security of Western Europe but also improve prospects for US coal exports. West European plans to diversify sources of coal

supplies will probably give the United States roughly a one-third share of the coal export market over the next two decades. At current prices, sales of US coal to Western Europe could amount to roughly \$3 billion in 1990 and \$4.5 to \$7 billion by 2000 compared with sales of \$1.9 billion in 1980.<sup>1</sup> [ ]

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To achieve maximum export levels, however, the US will have to expand sharply port capacity and dredge channels. Such measures would enhance the security of coal as an energy alternative and help restrain increases in coal prices. As the "swing" supplier in the coal market, the US share of the export market could be considerably higher depending on foreign coal supply disruptions. Largely as a result of filling Polish shortfalls, for example, US coal shipments to the European Economic Community increased by some 275,000 b/doe over the last two years. [ ]

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<sup>1</sup> Estimates based on current FOB coal prices at US ports. Delivery of coal by US flagships would further raise US revenues.



Steps which could be taken by European and Japanese  
Governments to Increase Coal Use

-- Continue development of infrastructure necessary to deliver coal to final consumers. This includes not only modern ports (where the Europeans, in particular, are far ahead of the U.S.) but also efficient rail and/or waterway systems which can transport coal inland at minimum cost.

-- Ensure that systems of support for domestic mining industries do not levy burdens on coal consumers by raising the price of coal above world market levels. If subsidies to mining industries are desirable, they should be paid from national treasuries to avoid distorting coal demand.

-- Introduce or continue financial measures (e.g. low interest loans, tax write offs) designed to reduce the burden of high capital costs on plans to convert to coal.

-- Re-examine environmental legislation to ensure that it does not levy inappropriate burdens on coal use.

-- Encourage continued research and development into new technologies that can increase coal use, including new methods of coal preparation and combustion, coal conversion to other energy forms, and resolution of environmental/logistical problems affecting coal use, such as ash and sludge disposal and sulfur dioxide control.

-- Continue strong political support for increased coal use. Facilitate dissemination of information on the advantages of coal use and the availability of coal.

The Real Cost of Soviet Gas

While the exact details of West European contracts to purchase gas from the Soviet Union have not been disclosed, there is a general consensus among the Europeans and major energy companies that the pricing terms are favorable. The real cost of Soviet gas, however, is not the contract price because it fails to take into account both the cost of subsidies used to finance construction of the pipeline and the cost of security measures needed to limit the impact of a gas supply disruption. Little reliable data are available to assess these costs.

Contract Terms

Complete details of Soviet contracts with West European utilities have not been disclosed. Information available on the West German contract, however, indicates that:

- o the base price is \$4.65 at the German-Czech border as of 1 July 1981 with payment to be made in deutchmarks.
- o the base price will escalate according to a formula indexed 20 percent to the price of crude oil, 40 percent to the the price of light heating oil and 40 percent to the price of heavy fuel oil,
- o there is an annual option to lift only 80 percent of contract volumes, and
- o there is a minimum or floor price which escalates in two phases to \$5.40 in 1984.

Should oil prices remain relatively flat or even decline through the mid-1980s, the West Germans would be faced with the prospect of paying the minimum price in the contract--an amount that could be well above prevailing natural gas prices. There is, however, conflicting information regarding operation of the minimum pricing provision.

- o One major Ruhrgas shareholder claims there is a "market out" or hardship clause which allows the utility to pay the going market rate for gas and pay the difference between that and the minimum price in future years.
- o Another shareholder claims the utility must pay the minimum price until the total excess payment equals about 10 percent of the cost of a year's deliveries. At that point, the contract would either be renegotiated or the Soviets would refund the accumulated money.

If oil prices rise sharply or keep pace with inflation, the minimum price provision would no longer be a factor.

#### Cost of Subsidies

The actual cost of Soviet gas is higher than stipulated in the contracts because of the cost of export subsidies provided by West European banks for financing construction of the pipeline. German bankers, for example, recently provided \$1.1 billion in credits at 7.8 percent interest--well below current market rates and the 12.5 percent minimum sought by the United States at the Versailles Summit.

The West Europeans claim, however, that much of the subsidy is being recouped through higher prices that are being charged to the Soviets for equipment and pipe. The difference in equipment prices has not been specified and would need to be considered in calculating the true cost of subsidies to the Soviet Union.

### Security Costs

The Soviet history of cutting back deliveries of gas during the period of peak winter demand and the expected higher level of Soviet sales have placed an additional cost on West European purchasers. To avoid the disruptive consequences of a shortfall of considerable magnitude in Soviet gas which could amount to more than 25 percent of expected gas needs, the Europeans will have to undertake a massive investment program. Among the steps being considered are:

- o large additions to gas storage capacity,
- o installation or maintenance of dual fuel systems to enhance fuel switching capability,
- o development of surge production capacity in domestic fields, and
- o integration of gas transmission grids to ensure that all areas can access alternative gas supplies.

All the costs of these security measures are not necessarily the result of increased imports of Soviet gas; the fact that Western Europe's gas demand and import requirements will grow dictates that some of these measures be undertaken in any event.

Still, some of the costs of security measures must be factored into the price of Soviet gas.

A great deal of technical information will have to be gathered to measure the cost of security measures to assess the real price of Soviet gas. Data on present storage capacity, dual fuel capability, and present surge capability are incomplete. To assess the cost of increasing flexibility of the gas transmission grid, a physical model of the current system including pipe size, field pressures, compressor stations, and switching capabilities is needed. The study on natural gas security currently being contemplated in the IEA would greatly enhance the capability to answer the question of the cost of security.

Washington, DC, 20505

## DIRECTORATE OF INTELLIGENCE

23 September 1982

Norwegian Gas Development: The LNG OptionSummary

Preliminary findings by a West German research firm show that it is economically, commercially and technically feasible to exploit and deliver northern Norwegian natural gas in the form of LNG to European markets. Although sufficient reserves for a project have yet to be proven, exploratory drilling in the region indicates a substantial reserve potential. At present, production from the area is not anticipated before the mid-1990s. According to industry estimates, however, an LNG project could be brought on stream sooner and provide Western Europe with additional alternatives to Soviet gas. Any potential US interest in purchasing Norwegian LNG would probably accelerate development. The US may want to explore strategies for marketing the gas particularly now that the Norwegians appear more receptive to speeding up northern sector development.

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Norwegian Gas Development: The LNG OptionThe Kiel Institute Report

The Kiel Institute for World Economics has recently completed an as yet unpublished report indicating that it is possible to deliver northern Norwegian natural gas in the form of LNG to West European markets at a competitive price. According to the report, up to 5 billion cubic meters per year of natural gas could be produced from the Tromsa area, using multiple wells and a fixed platform. The gas could be piped to a liquefaction plant operated on a barge and then transported in tankers to continental Europe. [REDACTED]

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The report contends that such a project would be economically viable. Assuming a base c.i.f. selling price of \$4.75, the project would yield a net cash flow after capital recovery of \$3.74 per MMBtu (1982 dollars and based on the DM 2.27/dollar exchange rate). Regasification costs would add another \$.55 to the cost of gas for West European purchasers. [REDACTED]

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Drilling and Exploration Activity

Geological surveys suggest that there are vast oil and gas bearing sediments off the northern Norwegian coast. The Tromsa area located north of the 62nd parallel has probable reserves on the order of 140-250 billion cubic meters (bcm), and Norwegian energy officials believe the area has considerable potential reserves in addition. Although no commercial discovery has been made, the prospects appear promising. [REDACTED]

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Development in the northern sector has been severely constrained by a short legal limit on the drilling season. This should change, however, given the Storting's (Parliament) recent decision to gradually lengthen the drilling season. Extending the season from 5 to 12 months over the next three years should considerably boost drilling activity. [REDACTED]

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The Impetus to Develop

While the Norwegian Government has traditionally pursued a "go slow" policy for offshore development, Norwegian Prime Minister Willoch recently underscored his country's willingness and ability to deliver substantial volumes of gas to Western Europe. He invited European governments and gas utilities to explore possible ways of establishing a supply strategy for the 1990s. Stressing the need for policy adjustment, Willoch asserted that once reserves are established they "should be acted upon." [REDACTED]

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The government's willingness to alter the pace of development may stem from the following factors:

- o Lower than expected oil revenues are beginning to make it difficult for the government to pay for its numerous social welfare programs and at the same time keep its promise to cut personal taxes. The continuation of a weak oil market, as forecast by most industry analysts, could induce the present government to accelerate gas development.
- o The government is deeply concerned about the imbalance between the prosperous southern sector of the country and the more economically depressed northern portion. Attempts to prop up traditional industries have not stopped the steady erosion of Norway's manufacturing base nor the continuing migration of its labor force to the south. The development of major new industrial projects in the north could help reduce this regional imbalance.
- o The government is aware that it will take some 10-15 years to bring Norway's natural gas reserves on stream. In the meantime, potential customers will be signing long-term gas contracts with other suppliers including the Soviet Union. In private conversations with US Government officials, the Norwegians have exhibited a growing concern that weak demand and competition from the Soviets could preempt the market for Norwegian gas if action is not taken soon. [REDACTED]

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#### Development Options

Although production from the Tromsa area is unlikely before the mid-1990s, the Norwegians are examining alternative strategies for bringing the gas to market. [REDACTED]

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Several development options are currently being considered:

- o Pipeline to Oslo and then on to the Continent. This option offers the political advantage of keeping as much infrastructure and business in Norway as possible. In addition, potential gas supplies from the Haltenbanken and Traenbanken fields could be linked into the pipeline. Despite these benefits, the topography of the land through which the pipeline would transit poses serious technical difficulties and make the cost extremely high. Norsk Hydro is apparently "seriously studying" this option.
- o Pipeline through Sweden to the Continent. Two of Sweden's state companies have already embarked on a \$18 million preliminary study of the scheme. The Swedes



would welcome not only a share of the gas but the accompanying benefits to their economy.

- o Pipeline along Norway's Coast. Because of potential costs and technical problems, this option has not received much serious attention.
- o Pipeline to Norwegian Coast. Some thought is currently being given to using the gas onshore in the northern section of the country to generate electricity. This option would be particularly attractive if total gas reserves from the region turn out to be in the 200 bcm range. [ ] 25X1

At present, estimated reserves in the Tromsa area do not warrant construction of a pipeline. Substantial volumes of gas would need to be marketed in order to recoup some of the investment costs associated with constructing a pipeline. Some market analysts contend that total recoverable reserves of approximately 400 bcm are necessary to warrant construction of a pipeline to the Continent; some Norwegian Government officials, on the other hand, maintain that a minimum of 600 bcm is required. [ ] 25X1

Moreover, even if substantial reserves were currently available to warrant construction of a pipeline, the Norwegians would most likely experience difficulty in marketing the gas. Lowered projections of West European gas imports have already affected contract negotiations for gas supplies from several producers. [ ] 25X1

[ ] a major US oil company [ ] believes there will be insufficient demand in Western Europe to justify construction of another major pipeline in the 1990s. [ ] 25X1 25X1

#### The LNG Option

There appears to be some support for developing an LNG project. Last month Statoil announced plans to liquefy gas from the Askeladden field located in the Tromsa area and to transport it by tanker. Statoil maintains that an LNG project would be economically attractive particularly in light of the relatively small volume of gas likely to be found in the field; recoverable gas reserves are estimated at between 140-250 bcm. The small size of the project would considerably improve the chances of marketing the gas. [ ] 25X1

Statoil claims that adoption of a two-stage development scheme with an LNG project first, followed by construction of a pipeline to the Continent when additional reserves are discovered, would accelerate by as much as five years the lead time required to bring production on stream. The company emphasizes, however, that in order to start production by the mid-1990s, development work would need to begin in 1985. [ ] 25X1

The US Embassy in Oslo reports that Norwegian Government officials are less certain about the feasibility of the Statoil proposal and doubtful that it would significantly speed up initial production. Moreover, Statoil's desire to develop the Askeladden structure in a separate scheme may not be fully supported by the Norwegian Government which has indicated that a coordinated effort would be the best solution for producing and marketing Norwegian gas in the 1990s. [ ]

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### A Potential US Role?

Should the Norwegians desire to actively explore the possibility of an LNG project, any US interest in purchasing gas would be welcomed and might conceivably speed development of the Tromsa area. There are several reasons why the United States might be interested in importing Norwegian LNG:

- o Although there is a current surplus of gas in the United States, several forecasts by major US oil companies indicate that incremental supplies may be needed by the mid-1990s to offset projected declines in domestic production.
- o Shipments of Norwegian LNG could utilize the regasification facilities at Cove Point, Maryland and Elba Island, Georgia. Both facilities have been idle since 1980 when Algeria suspended deliveries to the El Paso Company.
- o Additional gas supplies may be needed to meet peak demand on the US East Coast during the winter months and LNG shipments would allow this flexibility.
- o Importing Norwegian gas would enhance US energy security by minimizing dependence on Algeria. Also, any Algerian gas that is backed out of the US market would be available to the West European market.

In addition, US interest in Norwegian gas would contribute to the Norwegians' desire to diversify their markets. [ ]

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While the distances between northern Norway and the United States are roughly comparable to the distance between Algeria and the United States, importing Norwegian gas could prove more costly than Algerian LNG. The delivered cost of Norwegian LNG to the US would be perhaps \$1.00 higher than Algerian gas because Norwegian production costs are generally greater due to the remoteness of North Sea reserves. Norwegian insistence that their gas be sold at crude oil parity could also render it difficult to market LNG in the United States. [ ]

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OVERVIEW

ALTERNATIVE ENERGY GROUP AGENDA

(10:00 a.m. August 4, Room 7208 State Department)

1. Analytical Update (Henry Rowen)
2. Domestic Policy Choices (Options for each of the following policies are included in Section III of the Briefing Book)

- a. Alaskan Oil Exports to Japan
- b. U.S. ports
- c. Slurry pipelines
- d. Rail rates
- e. Deregulation of Gas Prices
- f. Nuclear regulatory reforms

3. Report of Ambassador Galbraith

4. International Measures (The briefing book contains a country-by-country summary of international gas alternatives including preliminary perspectives on (1) economics; (2) obstacles; and (3) possible US measures to assist development. This section is provided as an introduction to the international issues confronting the Group.)

5. NSC Meeting.

6. Next Alternative Energy Group Meeting (August 16)



Impact of U.S. Exports on Western Energy Outlook**Western Europe**

The consensus of government and industry forecasts for the European energy market indicates that Western Europe's imports of both coal and natural gas will increase substantially over the next two decades while oil consumption declines slightly from current levels. Exports of coal from the United States will face considerable competition but could account for as much as one third of West European coal imports in 1990, or about 3 percent of total energy demand. The world steam coal export market is currently demand constrained and this condition is likely to persist throughout the next two decades with abundant supplies available from South Africa, the US, Colombia, Poland, and other countries. [REDACTED]

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European governments are anxious to see the United States take steps which they believe will facilitate coal exports and help to restrain increases in coal prices. They believe that such measures would reflect serious US concern about European energy prices. According to the coal director of the European Economic Commission, the inability of US ports to accommodate vessels of 100,000 deadweight tons (dwt) and rapidly increasing rail transportation costs in the US could restrict European purchases of US coal with the possible result of greater coal imports from other sources. With ocean freight rates accounting for 20-35 percent of the delivered price of steam coal, future world coal trade is likely to be dominated by large colliers of 100,000 to 150,000 dwt in order to capture economies of scale. Currently, all major foreign coal-exporting countries as well as Japan and the importing countries of Western Europe have available at least one coal terminal that can accommodate vessels of 100,000 dwt and up, and more are planned. Unless deeper channels are dredged or alternate coal loading technologies are developed in the US, a significant portion of coal will move in ships too large to call at present US ports by the year 2000. [REDACTED]

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Substitution of US coal for gas in Western Europe, however, will also be constrained by economic and technical factors in European energy markets. About 60 percent of the increase in Europe's gas use over the next decade is expected to be in the industrial sector, while nearly 40 percent will be in the residential sector. In both sectors, coal is likely to directly substitute for gas only in very limited circumstances. [REDACTED]

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Industrial

Prospects for gas use and substitution of other fuels in European industries are mixed. Gas use in industrial boilers -- the largest industrial consumer of energy -- is expected to trend upward. With capital costs for coal fired boilers between three [REDACTED]

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and four times as high as oil or gas boilers, high interest rates and long payback periods will deter early retirement of existing oil or gas boilers. Coal is likely to make inroads only where boilers are needed at new sites and when boilers reach the end of their useful life -- primarily in the late 1980s and 1990s. [ ]

Constraints slowing the move to coal in all European industries are:

- o lack of coal stocking areas
- o inadequate coal distribution infrastructure
- o lack of ash disposal sites
- o environmental restrictions [ ]

Oil and gas will remain strong competitors for future markets. Because many long term gas contracts tie gas prices to the prices of competing fuel oils, a major shift in the relative prices of the two fuels is not expected. A sharp decline in real oil prices, however, could leave European gas distributors with a large amount of expensive Soviet gas to market. New contracts for imports of Soviet gas contain a price floor provision which specifies that European buyers must pay at least \$5.40 per million BTU for the gas regardless of the level of other energy prices. This could be a major problem if oil prices decline.

[ ]

### Residential

Residential heating demand will be the fastest growing market for gas in Western Europe. Despite the rapid increases in gas prices, gas is still the cheapest means of home heating. The relative cost advantage of gas is expected to erode, however, as low cost domestic supplies are gradually replaced by higher priced imports. Coal fired district heating systems and combined heat and power plants will likely slow the decline in domestic coal use particularly in Scandinavian countries, but the scope of coal usage in the residential sector is expected to decline overall.

[ ]

### Japan

While Japan currently relies on oil imports for more than 65 percent of total energy requirements, the Japanese are optimistic that oil dependence can be reduced to about 50 percent by 1990. Imports of gas and coal will account for most of the expected increase in energy demand over the next decade. [ ]

If 500,000 b/d of Alaskan oil were exported to Japan, the United States would account for 8 to 10 percent of Japan's oil imports in 1990. The United States is also likely to supply as much as 20 percent of Japan's coal imports, bringing total U.S. energy supplies to nearly 10 percent of Japanese energy demand.

[ ]

Japan Energy Supply and Demand Forecast

(million barrels per day oil equivalent)

	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>2000</u>
Coal	1.1	1.5	2.1	2.4
production	.2	.2	.3	.2
US imports	.25	.29	.4	.56
other imports	.65	1.01	1.4	1.64
Oil	5	6	5.5	5
US imports	0	.5	.5	0
other imports	5	5.5	5.0	5
Gas	.5	1	1.4	2.3
production	0	0	.1	.1
US imports	.5	1	1.3	2.2
Other Fuels	.7	1	1.3	2.7
Total	7.3	9.5	10.3	12.4

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Western Europe Energy Supply and Demand Forecast

(million barrels per day oil equivalent)

	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>2000</u>
Coal	5.5	6.1	7.2	8.7
production	4.3	4.5	4.7	5.1
US imports	.8	1.0	1.7	2.4
other imports	.4	.6	.8	1.2
Oil	13.5	13	12.5	13.5
production	2.5	3.5	3	3.5
US imports	11	9.5	9.5	10
Gas	3.7	4.2	4.9	5.7
production	3.3	3.2	3.2	2.7
US imports	.4	1	1.7	3
Other Fuels	3.2	4.4	5.6	6.5
Total	25.9	27.7	30.2	34.4

U.S. ENERGY SUPPLY AND DEMAND BALANCE TO THE YEAR 2000  
(MMB/DOE)

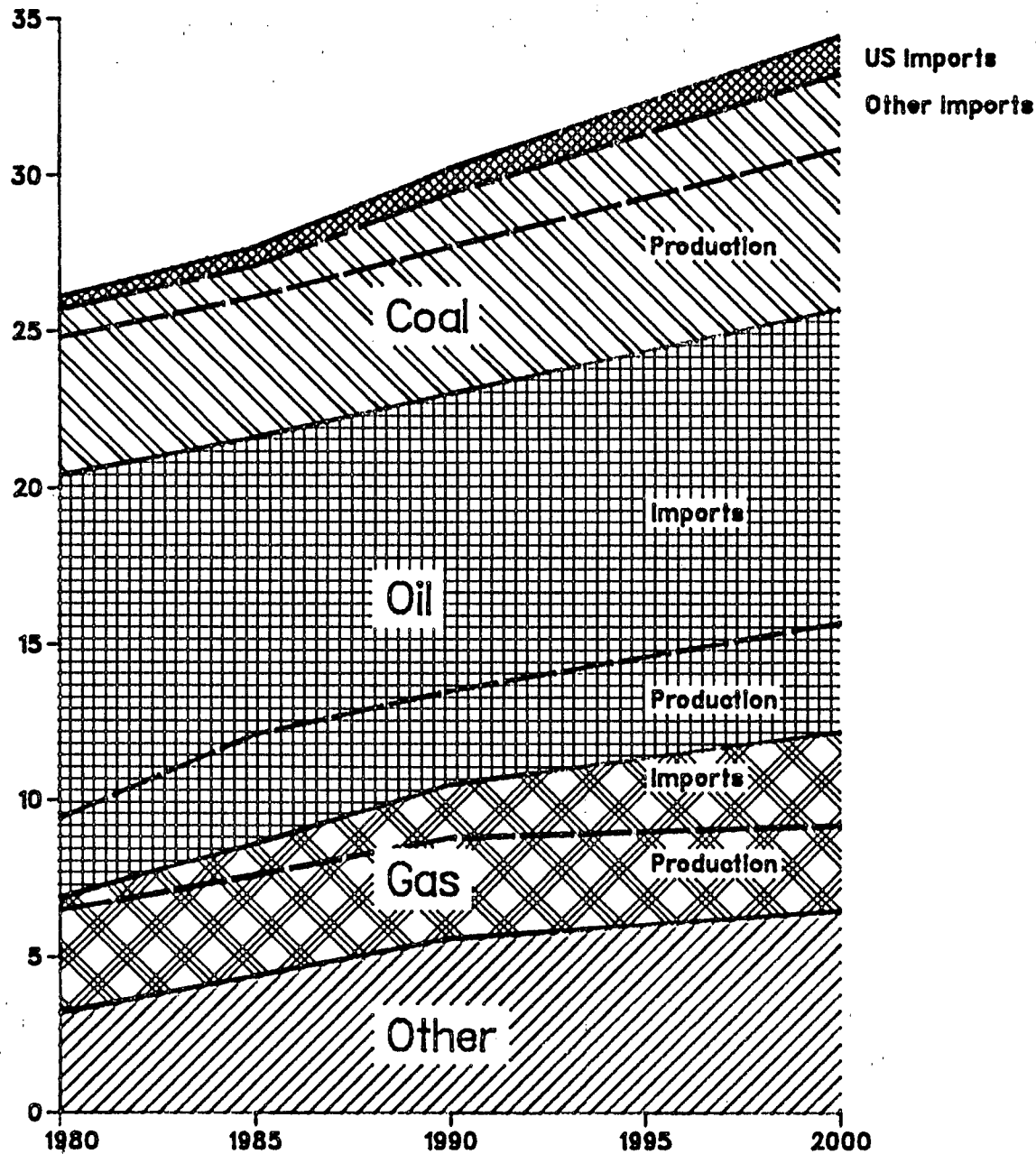
	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>2000</u>
<u>OIL</u>				
Consumption	17.1	15.7	15.2	13.7
Production	10.8	9.8	9.2	8.7
Net Imports	6.4	5.9	6.0	5.0
<u>NATURAL GAS</u>				
Consumption	9.8	9.5	9.6	9.6
Production	9.3	8.8	8.7	8.6
Net Imports	0.5	0.7	0.9	1.0
<u>COAL</u>				
Consumption	7.7	8.9	10.5	14.3
Production	8.9	10.4	12.9	17.7
Net Exports	1.2	1.5	2.4	3.4
which: W. Europe	0.8	1.0	1.7	2.4
Japan	0.25	0.3	0.4	0.6
<u>OTHER</u>				
Consumption	3.7	4.9	6.3	8.8
Production	3.7	4.9	6.3	8.8
Net Trade	*	*	*	*
<u>TOTAL</u>				
Consumption	38.3	39.0	41.6	46.4
Production	32.7	33.9	37.1	43.8
Net Imports	5.6	5.1	4.5	2.6

\* negligible

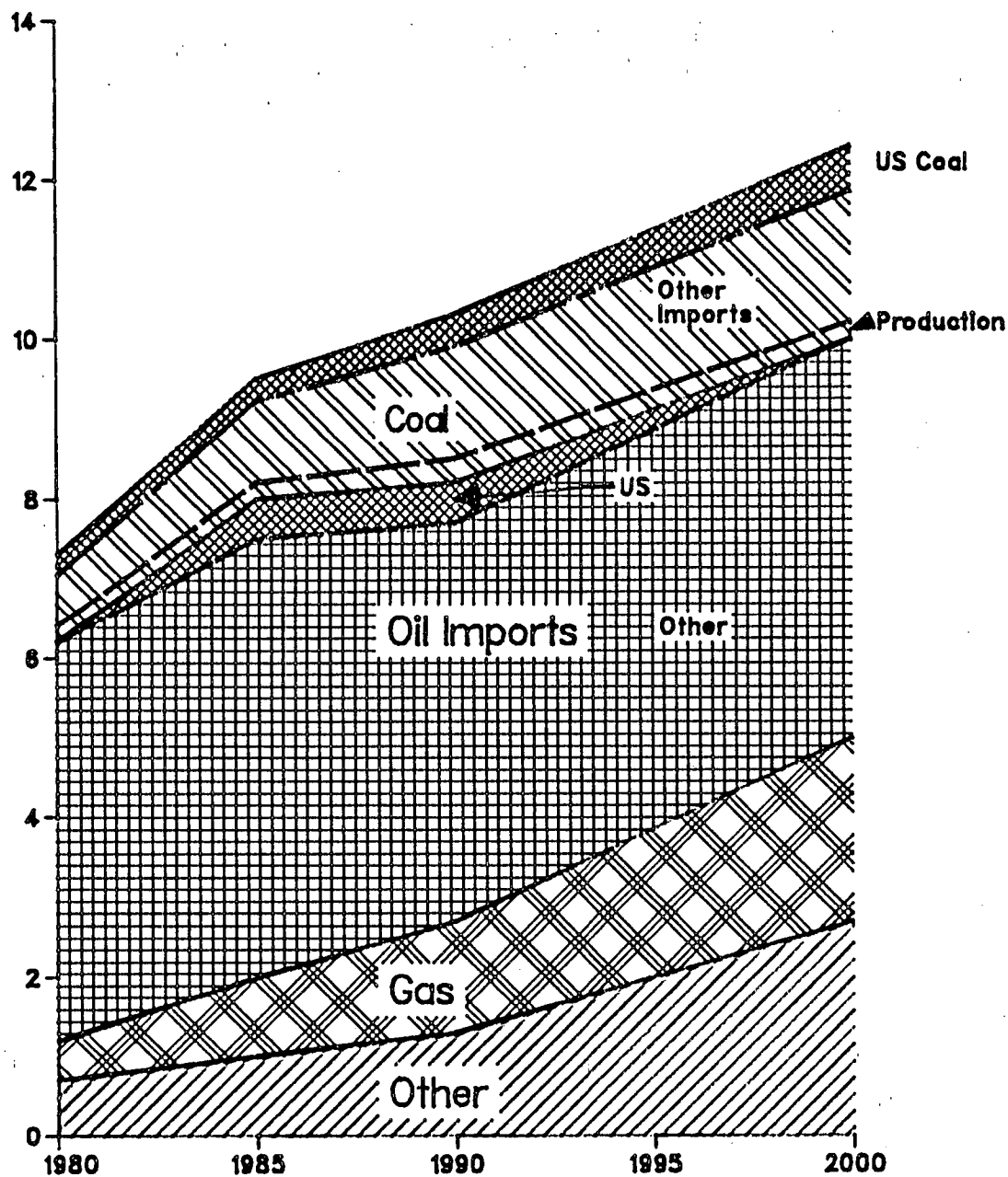
IA/1MPA  
7/30/82

# Western Europe: Energy Supply and Demand

(million barrels per day oil equivalent)



# Japan: Energy Supply and Demand (million barrels per day oil equivalent)



POLICY OPTIONS

Oil Exports to  
Japan

Objective: Allow Alaskan Oil Exports to Japan

Issue: Current law essentially forbids the export of Alaskan crude oil. Japan has long been interested in purchasing Alaskan oil for commercial and energy security reasons, and that interest has been intensified by pressure to redress the U.S.-Japan trade imbalance. The Japanese have also told us that availability of Alaskan oil would moderate public reaction to our Sakhalin sanctions.

Analysis: An extensive study by a Cabinet Council on Natural Resources and Environment (CCNRE) Working Group last year focused on our commitment to free trade and a deregulated economy as primary reasons for changing the law on this point. That study found that such an action would:

- Result in export of about 500,000 bbl/day of oil to Japan, out of a total production of about 1.6 million bbl/day.

- Increase economic efficiency by allowing Alaskan oil prices to rise to the world oil price, thereby increasing incentives for production of potential resources.

- Eliminate the need for 2,840 American jobs in the U.S. shipping industry and 49 vessels, which would eventually be laid up or scrapped.

- Have an uncertain impact on the federal budget, because of uncertain: 1) oil prices and volume effects relating to collection of revenues under the windfall profits tax, and 2) outlays resulting from guaranteed ban defaults on domestic oil tankers and purchases of tankers for defense purposes. Net budgetary impacts are estimated to range from -.06 billion to +1.47 billion over the period FY 83-FY 87.

- Have a beneficial effect on relations with Japan, and on our credibility with our other allies as a reliable trading partner in the energy field, but have a negative effect on our relations with Panama, which derives significant revenues from transshipment of Alaskan oil.

- Reduce availability of U.S. tankers to meet national security requirements in an emergency.

It has been suggested that the negative effects of such a decision on the U.S. maritime industry could be alleviated by requiring that some portion of the oil exported be shipped in American vessels. The CCNRE Working Group concluded that this would save 15-20 percent of the jobs that would be lost. However, such a solution would also present serious conflicts with treaty obligations to some of our major trading partners, and with our overall international economic policy which favors reduction of barriers to trade in services and opposes attempts by LDCs to impose cargo preference.

- 2 -

Options:

1. Seek removal of legislative restrictions on exports, and allow market forces to determine destination of oil as well as means of transport.
2. Negotiate with the Japanese a voluntary commitment to ship their eventual Alaskan oil purchases in U.S.-flag vessels. Then seek removal of restrictions on exports of Alaskan oil to Japan, but firmly resist attempts to legislate any such cargo preference requirements.
3. Seek gradual phased removal over a 5- or 10-year period of restrictions on exports.
4. Limit legal restrictions on export of Alaskan oil to current level of production, making any increase of production available for export.

Past Administration Decisions: Based on the work of the Working Group, options 1 and 2 were considered by the Cabinet Council last November. At that time, no decision was made to seek Alaskan oil export legislation.



Objective: Allow Alaskan oil exports to Japan

Option No. 1. Seek removal of legislative restrictions on exports, and allow market forces to determine destination of oil as well as means of transport.

Pros:

- Consistent with Administration's emphasis on allowing free play of market forces.
- Would be welcomed by the Japanese, who will use such a decision to moderate domestic political reaction to our decision on Sakhalin sanctions.
- Consistent with U.S. international commitments and foreign policy objectives.
- Could have favorable budgetary impact, depending on windfall profits tax receipts.

Cons:

- Substantial adverse effect on U.S. maritime industry, with resultant vociferous opposition on the Hill by maritime interests.
- Would be fought by political interests, e.g. AFL-CIO, opposed to any export of U.S. oil.
- Could have significant budgetary costs, depending on loan guarantee defaults and purchases of tankers for defense purposes.
- May impair U.S. relations with Panama, which is about to complete a major trans-isthmus pipeline to carry Alaskan oil bound for the U.S. East Coast.

Analytical Background:

This is the "cleanest" option. It corresponds most closely to the Administration's domestic and international economic policies, but is likely to be strongly opposed by maritime interests -- which was a primary reason for the November 1981 decision not to pursue this course of action.

Political Strategy and Timing:

To succeed, this option would require intensive involvement by the Administration's highest levels, and supporters will probably need to show a significant quid pro quo from the Japanese to justify the concession. It would be prudent to wait until after the November elections before pursuing this option.

Objective: Allow Alaskan Oil Export to Japan

Option No. 2: Negotiate with the Japanese a voluntary commitment to ship their eventual Alaskan oil purchases in U.S.-flag vessels. Then seek removal of restrictions on exports of Alaskan oil to Japan, but firmly resist attempts to legislate any such cargo preference requirements.

Pros:

- Achieves the benefits of cargo preference for the U.S. maritime industry without violating our treaties of Friendship, Commerce and Navigation.
- Might soften maritime industry opposition and thus congressional reluctance to allowing export of Alaskan oil.
- Would be welcomed by the Japanese, assuming the cost to them of protection for U.S. maritime industry is not excessive.

Cons:

- May irritate our major trading partners, as this represents a de facto weakening of our free trade stance against new cargo preference arrangements. As such, it may constitute a dangerous precedent.
- Permitting exports to one country only is a clear violation of the Most-Favored-Nation provision (Article 1) of the GATT.
- Unlikely to satisfy maritime industry because the majority of vessels currently engaged in Alaska-Gulf trade are too small to be converted to Alaska-Japan trade, and the number of jobs lost would substantially exceed the number gained because of cargo preference.
- Could lead to maritime industry insistence that cargo preference agreement be written into legislation. If Congress acquiesced, this would present the Administration with severe foreign policy problems. (Veto would alienate the Japanese; signature would violate our treaties and seriously obstruct our trade policy objectives.)
- Could lead to maritime industry insistence on -- and possibly passage of -- similar cargo preference for U.S. coal, which would have a severe adverse effect on coal exports.

- 2 -

Analytical Background:

The CCNRE Working Group noted that because of the small size of ships being used in the Alaska-Gulf trade even if all oil exported was carried on U.S. vessels, cargo preference would preserve only 15-20 percent of the jobs lost by removing export restrictions. This would be accompanied by increased costs to the Japanese (from \$.51-.84 per bbl. on world market tankers to \$1.10 per bbl. on U.S.-flag tankers). The Japanese could probably be persuaded to agree to "voluntary" cargo preference. However, legislation would still be required to remove the restriction on U.S. exports of Alaskan oil, and would no doubt become a magnet for unacceptable amendments by maritime interests. If the legislation were nondiscriminatory, it would open the possibility of shipment of Alaskan oil to third countries in non U.S.-flag vessels. If it were Japan-specific, it would put us in violation of the GATT.

Political Strategy and Timing:

The first step, which could be taken immediately, would be to ascertain whether a compromise of this type would be acceptable to the Japanese. Later this year, consultations with congressional leaders could be undertaken, a satisfactory "voluntary" agreement with the Japanese could be worked out and appropriate legislation could be offered early next year. While the Japanese would possibly be willing to pay the increased costs involved in using U.S.-flag carriers as a security premium, the maritime industry would probably oppose this solution because of the substantial job and vessel losses involved, or seek unacceptable concessions in other areas. Intensive high-level Administration involvement would probably be necessary to obtain passage of acceptable legislation.

Objective: Allow Alaskan Oil Exports to Japan

Option No. 3: Seek gradual phased removal over a 5- or 10-year period of restrictions on exports.

Pros:

- Will be welcomed by the Japanese as a favorable, albeit not very strong, political gesture which will gradually allow them access to Alaskan oil.
- Will ease impact on U.S. maritime interests, stretching it out over a 5- or 10-year period.
- Consistent with U.S. treaty commitments and foreign policy objectives.

Cons:

- Substantial adverse effect on U.S. maritime industry, with resultant vociferous opposition on the Hill by maritime interests.
- Would be fought by political interests, e.g. AFL-CIO, opposed to any export of U.S. oil.
- Could have significant budgetary costs, depending on loan guarantee defaults and purchases of tankers for defense purposes.
- May impair U.S. relations with Panama, which is about to complete a major trans-isthmus pipeline to carry Alaskan oil bound for the U.S. East Coast.
- Would require some mechanism (perhaps an auction) to allocate the right to export crude.

Analytical Background:

This option would attenuate somewhat the negative effects of removing export restrictions on the U.S. maritime industry, but would not eliminate them. The phase-out period would presumably give maritime interests time to adjust to the new market conditions, and avoid mass loss of jobs and defaults on loans to shipowners. It would be seen as a substantial positive move by the Japanese and would indicate our political will to overcome the obstacles to market forces in our energy system.

Political Strategy and Timing:

The political obstacles to this option are essentially the same as those to Option 1, although this option presents some moderation in placating maritime interests. Sustained high-level Administration involvement would be necessary to obtain passage of the necessary legislation, and avoid unacceptable amendments by maritime interests.

Objective: Allow Alaskan Oil Exports to Japan

Option No. 4: Limit legal restrictions on export of Alaskan oil to current level of production, making any increase of production available for export.

Pros:

- Likely to be more acceptable to U.S. maritime interests.
- Will not violate U.S. international commitments.
- Removal of legislative impediments, letting market forces determine the flow of any supplemental oil, would demonstrate U.S. willingness to become a reliable supplier as well as show concern for Japan's energy security.

Cons:

- Willingness of Trans-Alaska pipeline owners to expand shipments is not certain. Higher production now may mean shorter life of oil fields, shorter useful life of pipeline, or unacceptably high prices to cover premature depletion.
- Expansion of shipments would require investment of several billion dollars which may make Alaskan oil uneconomical for the Japanese.
- Likely to arouse opposition from political interests opposed to any export of U.S. oil.
- Would require some mechanism (perhaps an auction) to allocate the right to export the supplementary crude.

Analytical Background:

The Trans-Alaska Pipeline System currently is pumping at capacity of about 1.6 million bbl/day, although the pipe itself can be expanded to a capacity of 2.1 million bbl/day by increasing throughput, which would require addition of new equipment such as pumping stations. It would be possible to authorize export of the additional capacity, but there would be a number of practical uncertainties, revolving around whether the cost of increasing the flow of oil would raise its cost above world market levels, thus dissuading Japanese purchasers.

Nevertheless, a decision to remove legal obstacles to the export of supplemental quantities of Alaskan oil could be presented as a concession to Japanese energy security which might someday become valuable, depending on world market developments. However, it should be kept in mind that in the short run, this alternative will provide little additional oil to Japan.

- 2 -

Political Strategy and Timing:

This option would reduce to a minimum the negative effect of oil exports on U.S. maritime interests, and it is hoped that they would not oppose legislation implementing it, although they might seek to attach to it unacceptable extraneous amendments. It might be subject to criticism (from oil companies involved in Alaska as well as from the Japanese) as meaningless because it does not address the structural obstacles to flow of additional oil to Japan.

Consultations with the Japanese and oil and maritime interests should be undertaken prior to a final decision on the merits of this option

Ports

Objective: Facilitate Dredging of U.S. Coal Ports

Issue: What can be done to break the logjam in Congress on user fee legislation?

Analysis: Use of larger coal-carrying vessels holds the prospect of significant economies of scale in transportation of U.S. coal to European and Japanese markets. Estimates of savings in the delivered price of U.S. coal to Europe from use of 120,000 dwt vessels range from \$3 to \$7, which can be compared with a current landed cost of \$60-\$65 per ton for thermal coal in northern Europe. However, U.S. coal is the highest priced - compared to Poland and South Africa - and while significant, this saving will not by itself change the relative price structure of supplies. U.S. coal ports are at present not deep enough (55 feet) to handle 120,000-ton vessels. The deepest U.S. East Coast coal port (Hampton Roads, Va.) is dredged to 45 feet and can fully load vessels of about 80-90,000 dwt. Today most steam coal is transported in smaller ships, but over the next decade, increasing amounts will be transported in larger colliers.

Many U.S. ports are eager to begin dredging projects to become more competitive in international trade. Some -- and in particular the major existing coal ports -- are willing to fund such projects themselves, from user fees or other sources, since this would be the most expeditious way to proceed. Traditionally, however, port improvement and maintenance has been a federal government responsibility, and current law prohibits ports from imposing user fees or initiating their own dredging projects without Congressional authorization. Also, the current process is time-consuming and cumbersome, taking up to 17 years for a given project.

Our allies regard the port dredging issue as a litmus test of U.S. resolve in the coal export area. Several European and Japanese ports have been or are being dredged to accommodate large colliers. They have told us that if the U.S. is truly interested in making itself a supplier of reliable, secure energy to Europe and Japan, we should provide for the most efficient possible trade. In previous discussions of alternatives to Soviet gas, they have repeatedly asked why we are not doing something to make U.S. coal more attractive, and have specifically pointed to port dredging, even though increased European coal use is not likely to directly displace important quantities of natural gas. The European Community has also told us that it believes that the delivered price of U.S. coal in Europe sets the European market price, which other (lower-cost) suppliers simply meet. The Commission believes that any increase or reduction in the cost of U.S. coal changes the relative European prices of coal, oil and gas.



- 2 -

Current Administration Policy

Early in 1981, the Administration proposed legislation to change the system of funding port maintenance and improvements to a market-oriented, user fee approach. The proposal was designed to accelerate channel deepening projects and to require channel users to pay the costs, instead of the taxpayer. Strong opposition arose from political interests associated with smaller ports, which believe they would be at a competitive disadvantage against high-volume ports which could generate larger revenues to use for port improvements. The FY 83 budget cut off funding for smaller and less efficient ports, which has significantly reduced small port opposition to user charges. Some progress was made in the Senate, but in recent months all legislation in this area has been stalemated by the conflict between the port industry and the Administration.

Options:

1. Assign a higher priority to generic port user fee legislation. Call upon key Congressional leaders to help fashion a strategy for obtaining early enactment of legislation to allow prompt starts on dredging projects in major ports, coal ports included.
2. Press hard for specific action on coal ports, agreeing if necessary to separate legislative consideration of user fees for coal ports from other user fee legislation.
3. Maintain current legislative priorities. Continue current budgetary pressure and negotiating efforts to achieve passage.

Objective: Coal Port Dredging

Option No. 1: Assign a higher priority to generic port user fee legislation. Call upon key Congressional leaders to help fashion a strategy for obtaining early enactment of legislation to allow prompt starts on dredging projects in major ports, coal ports included.

Pros:

- If announced as part of a package of energy measures, would indicate to the Europeans and Japanese renewed commitment to U.S. development of necessary coal export infrastructure.
- Would preserve Administration's commitment to user fee principle and determination by market forces of what infrastructure is built.

Cons:

- No immediate, concrete effect. Process of congressional negotiations could still take a very long time.
- Will offer a focus for criticism by industry and Congressional opponents of the user fee approach.
- Would add to already heavy legislative agenda, and possibly require participation of senior officials to obtain passage.

Analytical Background:

Agencies agree that the most economically efficient and cost-effective mechanism for funding port projects is the user fee approach, which allows market forces to determine the nature and pace of port deepening, and which allows state and/or local governments full autonomy in determining their own port plans. The only question is tactical: how can the Administration best obtain early passage of a bill embodying this approach?

Political Strategy and Timing:

The limited time remaining between now and the fall Congressional election recess makes it unlikely that legislation can be passed before the end of the year. A Presidential announcement of a major push to enact such legislation as part of a series of energy measures would be well received by the allies, but would require intensive follow-up during the recess and when Congress resumes session.

Objective: Coal Port Dredging

Option No. 2: Press hard for specific action on coal ports, agreeing if necessary to separate legislative consideration of user fees for coal ports from other user fee legislation.

Pros:

- Would indicate to Europeans and Japanese high level of commitment to rapidly bringing to fruition the U.S. commitment to development of necessary coal export infrastructure.
- Would provide a single concrete focus for Administration action in this area, possibly leading to early resolution of coal port dredging issue, and enactment of the user fee principle in legislation applicable to one category of ports.
- Would preserve Administration's commitment to user fee principle and determination by market forces of what infrastructure is built.
- Would be greeted favorably by coal industry, some port operators and associated political interests. A decision to push for a bill applicable only to coal ports might lessen resistance from small-port interests.

Cons:

- Would mean postponing and a possible decrease in impetus on the user fee approach for most ports and waterways.
- Would add to already heavy legislative agenda; might necessitate major Administration effort to obtain passage.

Analytical Background:

This approach, if successful, would have similar economic effects to Option 1. It would carry certain political costs, however, and might be seen by some as a backing away from the Administration commitment to the user fee principle for waterway operations and maintenance.

Political Strategy and Timing:

Final enactment of legislation before the Congressional election recess is highly unlikely. An announcement of a determination to press for legislation applicable to new coal port construction would be well received by the Europeans and Japanese and would lay the groundwork for early action when Congress resumes.

Objective: Coal Port Dredging

Option No. 3: Maintain current legislative priorities.  
Continue current budgetary pressure and negotiating efforts  
to achieve passage.

Pros:

- Would leave intact Administration's commitment to user fee approach for all waterways construction, operation and maintenance.
- Would not add to clogged legislative agenda.

Cons:

- Prospects for early enactment of any user fee bill are very uncertain.

Analytical Background:

This approach may be more politically viable, but it does not enhance the prospects for U.S. coal exports to Europe and Japan.

Political Strategy and Timing:

This option would require continuation of current efforts to move port legislation forward. Progress will depend on Congressional developments.

Slurry Pipelines

Administration Position on  
Eminent Domain for Coal Slurry Pipelines

ISSUE:

Should the Administration change its position of not supporting passage of legislation to extend federal eminent domain authority to coal slurry pipeline systems.

Analysis:

Most transportation modes enjoy eminent domain at the state level. Only natural gas pipelines have federal eminent domain. Oil pipelines had federal eminent domain until 1946-47 when the Cole Act expired. Slurry pipelines do not have recourse to eminent domain at the federal level, nor do they enjoy it in all states. It is claimed that development of slurry systems is impeded by the costly process of acquiring right-of-way, particularly where slurry systems must cross railroads, and that existing state authorities are not adequate to ensure development of an efficient transportation system. Slurry advocates argue that interstate pipelines are blocked or delayed unnecessarily by railroads at state levels. Recourse in the courts has been necessary.

Development of slurry systems is possible without federal legislation. Two relatively small systems have been built. One, the Black Mesa Pipeline, continues in operation. The other, the Consol-Cadiz Pipeline was shut down after the railroads reduced rates to levels which made the pipeline uneconomic. A major, interstate pipeline is in the final planning stages. Right-of-way can be acquired through market transactions or, in some cases, under state eminent domain. Because other authorities are available, the Administration views federal legislation as an intrusion upon states' rights to self-determination.

Slurry advocates say that slurry systems will provide cheaper transportation because their higher ratio of fixed costs makes them less sensitive to inflationary pressures than are railroads. The railroads disagree, and offer data to show the opposite. There isn't enough experience with slurry systems to prove either position, and most data come from engineering studies or from experience with other types of pipelines.

Water is also a controversial issue. A slurry system needs one ton of water for each ton of coal delivered. This has generated great controversy in water-short areas of the West. The legislation does nothing to upset the traditional powers of state governments to allocate waters within their boundaries. Nonetheless, many Westerners feel threatened by proposals to use their water for slurry systems. There is little concern about this east of the Mississippi.

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Passage of federal slurry legislation would facilitate development of slurry systems. It is likely that the possibility of slurry transport would lead to increased competition in the coal transportation sector.

Administration support for slurry legislation would generally be applauded by coal producers and coal-dependent electric utilities. Consumers of electricity from slurry-fed utility systems would benefit if slurry pipelines are cheaper. None of the proposed slurry systems is designed directly for export shipment, however, new systems would be proposed and foreign perceptions would be positively affected by the addition of an alternative transportation mode.

The major losers if a slurry industry develops will be the railroads. Slurry systems are a threat to railroad revenues, and rail spokesmen characterize slurry as "unfair" competition that will skim potential railroad revenues from high volume rail transport corridors. The major bill this year is H.R. 4230, introduced by Congressman Udall and others.

#### Current Policy:

The President signed a memorandum on November 16, 1981, stating the Administration will not support such legislation because it interferes with States' rights. Since 1965, slurry legislation has been supported by past administrations but has not passed Congress.

#### Political Strategy and Timing:

Slurry advocates are making a major push to have the legislation approved by Congress before the Fall recess. It has been reported favorably by the House Public Works Committee, but faces an uncertain future in the Senate. If it is approved, a decision on whether or not to veto could be required before the elections.

#### OPTIONS:

1. Inform key congressional leaders that the President will not veto slurry pipeline eminent domain legislation.
2. Continue existing policy of not supporting legislation granting federal eminent domain.

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OPTION 1:

Inform key congressional leaders that the President will not veto slurry pipeline eminent domain legislation.

Pros:

- Would indicate to Japanese (and Europeans to a lesser extent) U.S. interest in allowing new technologies to take their proper place in the coal transportation system, with possible long-term efficiencies.
- If such legislation is enacted, it could be expected to lead to construction of more coal pipelines than would be the case under state control, with attendant positive effects on economic activity and employment.

Cons:

- Could be interpreted as an weakening of Administration's position in favor of states' rights.
- Would elicit negative reactions from railroads who fear loss of potential revenues.
- Although the pipeline does not affect state water prerogatives, this option could be viewed in the West as a decision to allocate scarce water resources to slurry systems.



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OPTION 2:

Continue existing policy of not supporting legislation granting federal eminent domain.

Pros:

- Leaves eminent domain question in the hands of individual states, who are best equipped to judge local impacts and needs.
- Continues stated Administration position resulting from Presidential decision.
- Avoids negative reactions from railroads and associated political interests.

Cons:

- Would maintain perception now held by some Europeans and Japanese coal buyers that the Administration is not interested in assuring lowest transportation costs for U.S. coal.

Rail Rates

## ICC Proceeding on Deregulation of Export Coal Traffic

### ISSUE:

Should the President communicate to the Interstate Commerce Commission about its proceeding on the deregulation of export coal traffic?

### Analysis:

The Staggers Rail Act of 1980 was intended to improve railroad service, and to increase railroad profitability and market share by providing increased pricing flexibility and some deregulation of the rail industry. Specifically, it permits long-term contracts between shippers and railroads and sets rate thresholds tied to railroads' variable costs. Rates set below the threshold levels are exempt from ICC regulation. Experience under the Act is limited; however, both domestic and export coal rates have risen. The Staggers Act provides for complete exemption from ICC regulation where sufficient competition exists. The Norfolk and Western Railway Company petitioned the ICC to exempt from regulation export coal traffic handled by rail and moving through Atlantic and Gulf Coast ports. The case was broadened by the ICC to include any U.S. coal destined for export, and it becomes the most significant application thus far of the ICC's deregulation authority under the Staggers Act.

The principal issue in the proceeding is whether competition for coal in export markets protects buyers and shippers against monopolistic practices by the railroads. Shippers cite the fact that over 95% of mines serving export markets are served by only one railroad as evidence of railroad market power over coal transportation. It is further argued that rail industry dominance in coal transportation would allow rates that are unreasonable, as between shippers and the railroads - a result which would harm the coal industry and its ultimate competitiveness in world markets. It is charged this will lead to lower export levels and to exploitation of the coal industry by the rail industry. It is also pointed out that under the Staggers Rail Act, railroads are already permitted to negotiate long-term coal shipment contracts.

From the European and Japanese point of view, the action requested by the railroads is discriminatory because it would cover only coal destined for export, leaving domestically consumed coal to be covered by existing Staggers Act provisions of partial deregulation. This approach is perceived by foreign governments, electric utilities and coal importers, as well as the European Community as one of the most serious potential problems for U.S. coal exports.

-2-

Advocates of deregulation point out that foreign coal buyers enjoy two distinct, price-reducing advantages over domestic buyers in negotiating shipping contracts: 1) international competition from Australia, South Africa, Poland, etc., exerts downward pressure on the delivered price which foreign buyers are willing to pay; and 2) source competition among U.S. railroads and waterways further increases foreign bargaining power. For example, there are eight existing East and Gulf Coast coal ports and 13 other planned coal ports. These ports are served by five railroads, as well as by inland waterways. Under ICC regulation, export coal tariffs have been set higher than domestic rates for comparable hauls. Exemption from regulation, it is argued, would create an environment in which railroads and shippers could develop long-term contractual arrangements to ensure reliability of supply, service, and price, free of the threat of ICC intervention which hampers negotiation of such contracts. In view of the competitive environment for international coal, ICC regulation is argued to be unnecessary because market forces can be relied upon to establish rail rates and terms of service.

#### Current Administration Policy:

Five Executive Branch agencies have intervened in this proceeding. The Departments of State and Commerce filed jointly in opposing deregulation, and USTR also filed opposing comments. The Department of Transportation filed in favor of deregulation. OMB, while not commenting in the proceeding, would also favor deregulation. The Department of Justice filed, taking no position on deregulation, but stating it would favor deregulation given evidence of effective world competition and that railroads could effectively price discriminate among shippers.

#### OPTIONS:

1. Presidential letter to the ICC, stressing the importance of increased coal exports to national security objectives, and urging that it give due weight to these considerations in assessing any proposed decision in its proceeding.
2. Take no Presidential action in ICC proceeding.
3. Presidential letter the ICC, stressing the Administration's support of deregulation.

4. Letter to ICC saying that domestic + foreign the same.

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OPTION 1:

1. Presidential letter to the ICC, stressing the importance of increased coal exports to national security objectives, and urging that it give due weight to these considerations in assessing any proposed decision in its proceeding.

Pros:

- Provides concrete action to the limit of our ability to reduce foreign buyers' perceptions of discrimination in an area which has been of particular concern to European and Japanese coal importers.

Cons:

- Timing will be open to criticism (late in ICC proceedings).
- Runs counter to general Administration philosophy favoring less federal regulation.
- There is no agreement within the Administration as to whether continued regulation in the present case is a desirable outcome.

-4-

OPTION 2:

Take no Presidential action in ICC proceeding.

Pros:

- Avoids Presidential intervention in the proceedings of an independent regulatory commission where there is no Administration agreement on the desirable outcome.
- Is consistent with general Administration philosophy favoring less federal regulation.

Cons:

- May be perceived by foreign coal buyers as contrary to their interests.

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OPTION 3:

Presidential letter to the ICC stressing the Administrations support of deregulation.

Pros:

- Would emphasize Administration commitment to deregulation as a concept.
- Could increase railroad revenues

Cons:

- Could undermine belief of foreign coal buyers, especially Europeans, in U.S. committment to expansion and support of U.S. coal exports.
- Railroads may raise rates to levels which could reduce coal exports.

Prepared by:MCard:djl:8/2/82  
Wang #3663S

Deregulation  
of Gas Prices



7/29/82

## Domestic Natural Gas Deregulation

### Background/Analysis

Under current law the wellhead price of domestic gas production is controlled by the USG. On the average, controlled prices are about 60% of free market levels resulting in higher consumption and lower production than would be the case without controls. Under existing law domestic gas prices range from less than \$.50 mcf to as much as \$9.00 mcf depending on which of the 27 price control categories the gas applies to. New gas or gas discovered after 1978 is scheduled to be deregulated in 1985. Old gas price controls would be continued permanently until depletion occurs. Therefore, only partial decontrol will occur in 1985 assuming current law. As a result, in 1985 new gas prices are expected to rise above oil price equivalence while old gas remains controlled. In the aggregate, gas consumers will pay market prices in 1985, however, large price distortions will exist among producers and interstate transmission companies depending on the extent of "old gas" under contract versus new gas.

Historically, European countries have objected to U.S. gas price controls. They correctly argued the U.S. imported more oil and our gas reliant industries had an unfair competitive edge in the export market. This was particularly true for the petrochemical industry where U.S. exports to Europe are substantial. Several countries--United Kingdom, Netherlands--also control prices of gas below market levels.

Last year the Cabinet Council on Natural Resources and Environment undertook an analysis of the impacts of decontrol and presented a recommendation to the President for an accelerated three year complete deregulation schedule. DOE estimated that the impacts of the three year phase out compared to existing law resulted in net economic efficiency gain to the U.S. of \$17 billion in 1980 \$, and lower oil imports in 1985 of about 300,000 B/D.<sup>1/</sup> The estimated reduction in U.S. oil imports is 500,000 B/D compared to an extension of price controls beyond 1985. Decontrol also had the advantage of eliminating the complex, cumbersome wellhead regulatory structure imposed by current law.

<sup>1/</sup> Note that U.S. oil imports are estimated by DOE to be

Current Administration Policy

In principle, it was agreed within the Administration to support phased complete deregulation of natural gas by 1985. The President decided, however, not to send the decontrol proposal to Congress until a later date because of a very heavy legislative agenda including major fiscal/economic issues in 1982.

Accelerated natural gas deregulation remains an attractive proposal to the West European countries. It is also attractive domestically from an energy economic efficiency standpoint. There are significant Congressional hurdles that will require time and persistence to overcome. It would appear that the best time to work such a proposal would be later this year or in early 1983.

Nuclear

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NUCLEAR REGULATORY REFORM

Proposal

In October 1981, the President directed that proposals be prepared for nuclear regulatory reform with a goal to reduce significantly the time from planning to operation. The achievement of these reforms will partially affect nuclear power plants now under construction so that earlier completion of these facilities would permit nuclear generated electricity to displace oil and gas fired electricity. The reforms that DOE will propose are:

- o Administrative reforms
  - Management improvements
- o Legislative reforms which can also be partially implemented administratively
  - Pre-approved sites (early site environmental review)
  - Pre-approved designs (safety certification of plant or component)
  - Backfitting (major redesign during construction)
  - Amendments and variances (small design changes)
  - Hearings (limits scope of contentions and forbids raising previously resolved issues)
- o Legislative reforms
  - One step licensing (combined construction and operating license)
  - Make Advisory Committee on Reactor Safeguards (ACRS) review discretionary

Pros

- o The Presidential endorsement of these reforms will send a very positive signal to the international community of our commitment to rely on increased nuclear power.
- o Implementation of the reforms, through partial affect on plants under construction, could lead to 240 billion kilowatt-hours (320 million barrels of oil) being produced at an earlier time between now and 1990.

Cons:

- o The submission of the legislation while Congress is debating a nuclear waste management bill could be detrimental to both pieces of legislation

Status

The DOE Task Force Report addressed both administrative and legislative options. On May 7, 1982, the Report was sent by Secretary Edwards to NRC Chairman Palladino with a recommendation that NRC consider adoption of the administrative changes. A legislative package was approved by OMB in June and is now awaiting transmittal to Congress..

Next Steps

1. The legislative reform package should be transmitted to Congress, with a Presidential letter of endorsement, as soon as possible.
2. The NRC should be urged by the White House to undertake necessary steps to make recommended administrative changes by December 31, 1982.

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A. NORWAYEconomics

Norway currently supplies Europe with 27 bcm of gas, 11 bcm to Britain by way of the Frigg pipeline system and 16 bcm to Germany by pipeline from Ekofisk. The Ekofisk gas is priced at \$4.25 per million btu (mmbtu) c.i.f. Emden, and is competitive with Dutch and Soviet alternatives. A new "Statpipe" system will bring additional gas from northern fields to fill in the Ekofisk line's excess capacity (some 8 bcm/yr.), but the price for this gas, \$5.50 mmbtu, is high. This has led Belgian, German and French gas consuming companies to grumble about withdrawing from earlier commitments to purchase Statpipe gas, in view of poor market conditions.

Norway has huge gas reserves, but production and transportation costs are high. One of the largest fields in the world is the "Troll" structure in block 31/2. For Troll, a tie-in to the Frigg line to the U.K. is the least-cost development option, but even with additional compression Frigg could deliver only 26 bcm/yr. to the U.K., considerably less than the field is expected to be capable of producing. A trunkline to the continent to carry 38 bcm/yr. would entail capital costs of more than \$3 billion and take two to three years longer than the Frigg option. Gas from the Sleipner field could be available sooner, but the fractured geological structure will require at least five production platforms, and the high CO<sub>2</sub> content of Sleipner gas will raise development costs and limit transportation options.

In May a Special National Intelligence Estimate concluded that large additional supplies of Norwegian gas would probably cost 15 to 20 percent more than Soviet gas if no interest rate subsidies were offered for the Norwegian project. Nevertheless, there is definite commercial interest in Troll and Sleipner development, indicating that producers and consumers alike see this gas as potentially marketable in the early 1990's. Shell, operator of Troll, is moving ahead on a development plan and is expected to declare the field commercial in early 1983. It has commissioned six feasibility studies on development alternatives. Sleipner also is the subject of a full testing program and its operators, Statoil, Norsk Hydro and Esso will begin negotiations with 20 potential buyers in August-September, and propose a development plan to the GON in early 1983.

Obstacles

The principal obstacles to Norwegian gas development are price competition from the Soviet Union and potential political concerns in Norway, Holland and the U.K.

If European governments were willing to countenance even greater energy dependence, Soviet price competition is likely to be a very serious obstacle. The Soviets put a high value on hard currency, and in Siberia they have massive onshore gas reserves which are still untapped. Once the first pipeline is completed, a "second strand" line could be



built at a considerably lower capital cost. Moreover, even without a second line, the Soviets could try to undersell Western alternatives with gas allocated from its existing pipeline grid. The net result is that the Soviets will have a continuing cost advantage over new Norwegian gas which they are likely to exploit.

Political obstacles to Norwegian development are still hypothetical in advance of commercial development plans, but several problem areas can be foreseen. For example, there have been recent indications that Norway would rather have direct export lines to European markets, rather than using the U.K. as a "land-bridge" to Holland or France. (In a policy shift, the U.K. has recently expressed its amenability to such a deal, however). Norwegian insistence on a direct pipeline would delay development, and increase the cost of the gas.

A potential technical problem is the program for exploitation of the oil associated with the Troll field. The Norwegian government could require full extraction of the thin layer of oil before allowing gas production to begin (the technically optimum solution). A final constraint is Norway's legislative requirement that hydrocarbon production in the 1990's not exceed 90 mtoe (metric tons of oil equivalent), in order to protect the domestic economy. However, with the current softness in the oil markets, the GON may appreciate greater diversification in hydrocarbon exports.

#### Possible U.S. Policies

-- Continue quietly to encourage Dutch-Norwegian exchanges on gas development planning. Discuss Norwegian attitudes towards such cooperation with State Secretary Ramm August 16-17 (as suggested by Ambassadors Galbraith and Austad). Greater interim Dutch exports would protect potential Norwegian market share against Soviet encroachment.

-- Also during the Ramm visit explore Norwegian attitudes towards using the U.K. as a land-bridge for Norwegian supplies. We should encourage the use of the U.K. in view of the time savings, and promote a U.K.-Dutch pipeline system hook-up to land Norwegian gas in Holland. Such a link would be cheaper and shorter than a line to France, and would help solidify Norwegian-Dutch collaboration. We should limit the USG role to behind-the-scenes, however, as there are some indications that public statements on gas potential may be counterproductive in the Norwegian political context.

-- Set up a special USG task force to study: tax aspects of Norwegian gas development, (especially the interaction of the Norwegian tax system with the U.S., U.K. and Dutch systems), the proportion of costs accounted for by taxes on all parties, depreciation rules, and on a contingency basis, whether some form of offshore, indexed financial instrument may be created to allow the Norwegians to insulate their economy from the inflationary effects of rapid development while protecting the value of their financial assets.

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## B. UNITED KINGDOM

### Economics

The U.K. is largely self-sufficient in natural gas, and, compared to continental Europe, consumes a greater proportion in the residential and commercial sectors. Over 77 percent of consumption is supplied from natural gas production in the British sector of the North Sea, a large part of which is associated gas. The U.K. imports modest quantities of gas from Norway (via the Frigg system which also transports gas from the U.K. sector) and small quantities of LNG from Algeria for peak sharing purposes.

Domestic U.K. production has suffered from significant disincentives. First, the British Gas Corporation (BGC), a State entity, had monopsony power over all gas produced in the U.K. sector. Second, frequent changes in tax regimes and high marginal tax rates discouraged all hydrocarbon development. And administrative and regulatory delays have inhibited decisions on economically viable gas-gathering systems. Recently, HMG took steps to privatize BGC and amended the law to allow large industrial gas consumers to negotiate directly with gas producers. BGC still has a monopoly over the large and politically sensitive residential and commercial markets, however. Delivered prices are relatively low, but the government is implementing real annual price increases of 10% per year for three years.

The U.K. government, most oil companies and many private analysts expect the U.K. to remain roughly self-sufficient in gas over the coming two decades. A notable exception is Peter Odell, who believes that with proper production-oriented policies the U.K. could produce an exportable surplus by 1990. Recently the natural gas manager of Esso Europe told Embassy London that he expected that the U.K. could absorb all of the roughly 10 bcm/yr produced by Norway's Sleipner field, and still not have any domestic gas that could be exported to the Continent from the southern sector gas fields.

### Obstacles

Integrating the U.K. into the West European gas supply grid and obtaining full potential gas production from its offshore fields is an economic, as well as political challenge. HMG has recently expressed its willingness to serve as a "land-bridge" for moving Norwegian gas from northern fields to the Continent. But in view of potential British gas shortfalls Norwegian producers will need to have assurances that equivalent amounts will be shipped to Holland from the Southern U.K. in order to ensure that North Sea gas actually reaches Continental consumers. Another problem may arise in the negotiation of transit fees.

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And, even though the HMG currently expresses interest in the "land-bridge" concept, political opposition can be expected if and when a formal proposal is presented. Consumer groups will fear that the availability of continental markets for British gas will lead to higher retail prices, and conservatives will fear such a link would mean Britain would be forced to share in any European gas shortfall (such as that which might result from a Soviet cut-off).

Possible U.S. Policies

-- Encourage more realistic taxation and leasing policies, along with market based retail prices, in order to forestall a potential growing U.K. gas deficit and competition for Norweigan gas.

-- Support an interconnection between British and Dutch gas gathering systems in the Southern North Sea.

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C. NETHERLANDSEconomics

The Netherlands is currently Europe's largest and lowest-cost gas supplier. Dutch production in 1981 totalled 82.7 bcm, although exports were down 9.9% and domestic consumption was off 4.8%. Despite over twenty years of production, the official Dutch estimate of proven gas reserves is 2.1 trillion cubic meters (tcm). Well-informed industry sources believe reserves are considerably higher. The bulk of Dutch gas reserves are found in by the onshore Groningen field, an extremely large field with unusual geological characteristics that allow for great flexibility in production. The current Dutch export price is \$4.45 mmbtu at the border.

Before 1973 the Dutch sought to increase gas exports and maximize gas use in the Netherlands. Following the OAPEC oil embargo against it in 1973 Dutch policy shifted in part in order to "conserve" hydrocarbon assets for future generations, and in part to limit growth in public revenue that funded generous public services. Accordingly, during the late 1970's the Netherlands informed its customers that it would not be renewing gas export contracts as they expired between 1985-95, a decision which prompted European gas importers to look elsewhere (including the Soviet Union) for gas.

Recently, the recession and contract offtake flexibility have resulted in significant reductions in domestic and (especially) export sales. With attendant losses in government revenue, the Dutch have begun to rethink their conservationist policies. Commercially, they see their gas export markets going to other suppliers (the Soviets and Norwegians) and with oil price weakness there is some political sentiment that gas kept in the ground for future generations may not be sound economic planning. Financially, they need the revenue.

Unfortunately, one response to this financial bind has been a 15% price cut in gas sold domestically for power generation, in exchange for utility agreement to take an extra 4 bcm/yr. of gas for the period 1982-87. This short-sighted policy not only will use gas which might otherwise be available for export, but may reduce the incentive to build coal-fired electricity generation facilities. Even so, the Dutch were willing recently to "guarantee" to 1995 any residual Belgian gas needs so as to allow them refuse Soviet gas.

Obstacles

The Netherlands clearly has the gas reserves to continue to supply European export markets into the mid-1990's and, many observers believe that a more development-oriented tax and leasing policy would lead to significant additional discoveries off-shore. The major obstacles are political, and transcend normal party lines. In the dispute Dutch

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socialists concerned with protecting welfare funds from further cuts are allied with development-oriented conservatives. Fiscal conservatives interested in limiting growth of government spending oppose an increased production rate, and environmentalists are interested in preserving clean-burning gas for domestic needs. One problem is the now firmly ingrained public perception of the growing scarcity of gas reserves.

Ambassador Dyess has reported that the balance is shifting in favor of the exploitationists (as also evidenced by the help recently given to Belgium) but has warned against incautious and counter-productive U.S. moves, particularly before national elections on September 8. Nevertheless, it would be politically difficult for the Dutch to move completely to an all-out development and export policy. It has been already evident in discussions with the Belgians that the GON fears that partial reversal of its export phase-out policy in favor of one customer would lead to similar requests from all of its EC partners.

#### Possible U.S. Policies

-- Continue quietly but persuasively to encourage Dutch-Norwegian discussions on joint gas development schemes. A formal Norwegian request for Holland to sign several, limited 10-year export contracts to cover the needs of prospective Norwegian customers until Troll gas is available would help Holland out of its political bind by demonstrating that the export commitments would not be long but medium term in nature.

-- Renew U.S. efforts bilaterally and in the IEA to convince Holland to reduce its use of gas in power generation (currently 43% of electricity is generated in this way) in favor of U.S. coal, thus freeing gas for higher value export markets even without expanding production. Perhaps offer to expand R and D cooperation in pollution control equipment design.

-- Form a USG task force to examine Dutch tax and other policies governing oil and gas development in order to determine reasons for stagnation in reserve discoveries. Give particular attention to offshore areas.

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North Africa

~~SECRET~~B. North Africa/Algeria

Economics: With 3.2 tcm of proved reserves, Algeria holds the world's fourth largest gas reserves. As its oil exports -- the traditional major source of foreign exchange earnings -- are depleted, gas exports are becoming increasingly important to Algeria. Algeria currently has contracts to export some 37 bcm in a combination of LNG and pipeline gas, mostly to Western European customers. Of that figure, 12.5 bcm is scheduled to be delivered through the \$3 billion Trans-Mediterranean pipeline to Italy, while 24.5 bcm of LNG is contracted to French, Belgian, and U.S. customers. However, Algeria is delivering less than the equivalent of 11 bcm per year at the current time because of a variety of problems, mostly involving its demands for price renegotiation.

Over these amounts, it is conceivable that Algeria could deliver an additional 20.5 bcm in pipeline gas and 6.6 bcm in LNG to Europe by the mid-1990's. Such a boost in pipeline deliveries would require the construction of additional compressor stations on the existing but currently unused Trans-Medline, enabling 5.5 bcm of new supplies while a pipeline across the Mediterranean to Spain (the so-called Segamo project) could deliver 15 bcm. In addition, there has previously been discussion of construction of a new pipeline (Trans-Med II) parallel to the existing Trans-Med line, but this idea has faded because of Algeria's continuing refusal to begin deliveries to Italy from the Trans-Med line without a gas price increase. Although technical difficulties have plagued the history of Algeria's LNG operations, theoretical LNG production capacity is 31.1 bcm per year. Thus, it is possible that 6.6 bcm of LNG beyond currently contracted levels might be available for Western Europe.

Obstacles

-- A new CIA analysis indicates that Algeria will be able to meet only half of its current gas export commitments to Western Europe and the United States for the remainder of the decade, let alone increase exports. The CIA study cites unanticipated production problems in developing existing gas fields, Algeria's inability to accelerate development of new fields, and rising domestic consumption as the key reasons behind its judgement. [REDACTED]

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-- Algeria's militant pricing policy and its unilateral suspension of gas deliveries to France (since renewed) and the United States, in addition to its failure to begin scheduled deliveries to Italy, make it a highly unreliable supplier.

-- With an estimated CIF price in Europe of \$5.50 per MMBTU, Algerian gas would carry a heavy implicit "security" premium over Soviet gas, resulting in additional Western European gas costs of \$1.8-2.2 billion per year.

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-- On the LNG side, technical problems have limited Algerian production to only a fraction of designed plant capacity, and it is very uncertain that Algeria could ever reach full capacity necessary for a large increase in exports to Western Europe.

Possible U.S. Policies

-- We could press USG regulatory authorities not to authorize further imports of Algerian LNG into the U.S. Both the Trunkline (4.5 bcm per year) and Distrigas (1.4 bcm per year) contracts are expected to face new regulatory review this year because of renegotiated prices and escalator clauses; without a U.S. market, Algeria would have up to an additional 5.9 bcm per year to export to Europe.

-- Although most U.S. technical consultants (Pullman-Kellogg, El Paso) involved in Algerian gas development have now left the country or plan to do so in the near future, the USG could subsidize their employment in Algeria, perhaps through EXIM to ensure Algerian gas flows at maximum levels.

-- In order to make the Segamo project more attractive, EXIM could provide significant, low-cost credits to Algeria for the pipeline's construction.

-- The Maritime Administration (MARAD) could aid in promoting additional LNG supplies to Europe by selling at a favorable price the six LNG tankers from the El Paso project to either the Europeans (or their shipping representative) or to the Algerians. This action is predicated on MARAD's taking title, as expected, to the El Paso tankers. The former possible sale is more likely, as the Algerians have indicated that they do not want to undertake additional shipping contracts.

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~~SECRET~~B. North Africa/Nigeria

Economics: Two gas projects -- one pipeline and one LNG -- to deliver Nigerian gas to Europe have been discussed in recent years. Under the Bonny LNG project, Nigeria planned to provide gas supplies of 8.35 bcm per year to both the United States and Western European markets. With construction to begin in 1983 and completion scheduled for 1988, the project was slated originally to deliver gas to Europe at an estimated CIF price in Europe (as of January 1981) of \$5.49 per MMBTU. However, this price rose to \$6.19 per MMBTU by mid-1981 as a result of Nigeria's demand that its gas be priced comparable to Algerian gas. The Bonny project, with an estimated cost of at least \$15 billion by 1981 compared with initial estimates of \$5-7 billion, was to provide projected gross earnings to Nigeria of about \$185 billion over a 20-year period. Earnings to foreign companies were projected at about \$45 billion. Because of a number of reasons -- including the lack of a firm financial commitment by Nigeria, withdrawal of key foreign companies from the project, lower estimates of European gas demand, and Nigeria's insistence for gas prices at crude oil parity -- the Bonny group was liquidated in February 1982. However, the World Bank is currently investigating the feasibility of a new Bonny project, and the Nigerian Government has hired U.S. legal, technical and financial consultants to assess anew the project.

A pipeline that would annually carry about 15 bcm of Bonny gas through North Africa to Western Europe has also been considered. Three trans-Saharan routes for such a 2,250-2,600 mile pipeline have been considered, two of which transit Algeria. Although one preliminary industry estimate placed pipeline construction costs at \$10 billion, total costs would likely make the project financing requirements about equal to those of the Bonny LNG proposal. Because pipeline transport costs are considerably lower than costs associated with LNG transport, Nigeria could potentially realize a greater wellhead price for the Bonny gas by using a pipeline scheme than by undertaking an LNG project. In spite of lobbying efforts by Algeria and domestic proponents, the Nigerian Government rejected the pipeline proposal in early 1981 after the Algerians refused Nigeria's request to retain total control over any pipeline transiting Algeria. Nigerian politicians from northern states which would benefit from the pipeline continue to back the project, and Bechtel told the Nigerians in May that the pipeline was technically feasible.

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ObstaclesBonny LNG

-- A CIF price structure for Bonny gas comparable to Algerian gas prices would constitute a "security" premium over Soviet gas of \$.75 per MMBTU and would cost European consumers an additional \$450 million per year. Thus serious problems remain in pricing the gas to be competitive in the European fuels market.

-- As a result of declining oil revenues in the current soft world oil market, it is questionable that Nigeria has the foreign exchange necessary to finance its share of the project. Necessary initial Nigerian investment of \$10 billion would again be the subject of intense political debate, and would be an issue in the 1983 Presidential election.

Trans-Saharan Pipeline

-- Fees charged by countries the pipeline would transit could be exorbitant. In the event that the most direct route -- through Algeria -- were chosen, Algeria would undoubtedly charge a high transit fee to ensure that Nigerian gas was not more favorable priced than Algerian gas competing for the Western European market.

-- Local and regional political instability makes the project a high-risk proposition.

-- Because of extreme water depth in the Gibraltar Straits, technical problems could be encountered in constructing the pipeline and repairs would be both expensive and unwieldy.

-- Shell and other foreign producers are unwilling to consider any Nigerian gas project until the mid-1980's when they will reevaluate the European gas market and the Nigerian political situation.

Possible U.S. Policies

-- The USG could offer attractive Exim financing for either gas project. Current Exim lending rates, however, may not be a sufficient economic incentive for Nigeria to proceed, and extraordinary Exim financing might be required.

-- While possibly troublesome with other U.S. sources of crude imports, we could investigate the possible guaranteed purchase of large amounts of Nigerian oil for the U.S. Strategic Petroleum Reserve. The Nigerians have indicated they might earmark revenue from such sales specifically for gas export projects.

-- As in the case with Cameroon, the Maritime Administration could offer to Nigeria LNG tankers from the El Paso-Algeria LNG project at a favorable price and on favorable terms.

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## B. North Africa/Cameroon

Economics: Segazcam -- a consortium comprised of the Cameroon state oil company (Societe Nationale des Hydrocarbons), U.S. companies Mobil and Pecten (Shell), and French companies Elf-Aquitaine and Total -- is studying the feasibility of constructing an LNG facility in the Kribi region of southern Cameroon. While the project was originally targeted to serve both the European and U.S. gas markets, Europe is now considered the likely importer for the full volume. The estimated cost of the project, including construction of a three train liquefaction plant, infrastructure, and LNG tankers, is around \$10 billion.

Although the consortium initially anticipated LNG production capacity of 6 bcm a year, a recently-released and long-awaited study on Cameroon gas reserves prepared by Franlab Consultants (Institut Francais du Petrole) indicates that the project reserves are only about two-thirds the level previously expected. With total Cameroon gas reserves now estimated in the neighborhood of 100 bcm, the consortium -- led by the Cameroon Government -- is reportedly reassessing the viability of the project. As an alternate to scuttling the project, the size of the proposed plant could be reduced from six to four bcm annual capacity. Consortium members are also reviewing projections of European gas demand; while start-up date was originally planned for 1987, European demand figures suggest a more distant timescale. A final decision on the fate of the project is not expected until the end of 1983.

### Obstacles to development:

-- Smaller than anticipated Cameroon gas reserves may make the project uneconomic.

-- Uncertain European gas demand clouds the viability of even small LNG volumes available for export.

-- Given probable cost overruns, relatively small scale of project, and inherently more expensive LNG form of gas to importer, gas price (now unknown) may not be competitive with pipeline alternatives.

-- Project would probably not be on-stream before early 1990's at the earliest and might not be able to meet European gas requirements in the late 1980's and early 1990's.

### Possible U.S. Actions to Help Overcome Obstacles:

-- Exim could offer more attractive terms for the \$500 million in credits than have already been extended for the project's liquefaction contract. Pullman-Kellogg and Fluor, both U.S. companies, are competing with the French firm Technip for the contract.

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-- Alternatively, Exim could offer in excess of \$500 million in credits at attractive terms in support of Pullman-Kellogg and Fluor.

-- The Maritime Administration, which may in 1983 take ownership from El Paso of six LNG tankers used in the defunct El Paso project involving Algerian LNG, could offer the tankers to the Segazcam consortium at a favorable price and on favorable terms.

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Middle East



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### C. Middle East/Iran & Qatar

Economics: Three projects involving Persian Gulf gas exports to Europe are possible alternatives to increased Soviet gas. The most realistic proposal would utilize Qatar's North Dome offshore gas field, with reserves of 4.2-5.7 tcm, for LNG shipments of some 8.5 bcm per year equally split between Europe and Japan. Qatar's national petroleum company is now discussing the estimated \$5-6 billion project with European companies, including Winterhsall AG of West Germany, CFP (France), British Petroleum Co. Ltd., Royal Dutch/Shell, and Roy M. Huffington. These companies, with experience in LNG plant construction and operation, would hold a 15% interests in the project, while 5% would be allocated to Japanese companies with experience in LNG transportation and marketing. The Qatar General Petroleum Corporation (QCPC) would hold the remaining 80% interest. It is unlikely that this project could come on line before the late 1980's at the earliest.

The second proposal employing Persian Gulf gas centers on a pipeline which would gather gas from Qatar, the UAE, and possibly Kuwait and transit Iraq, Turkey, Greece, and Yugoslavia to connect with the European gas grid. Under an alternative proposal, the line would cross Saudi Arabia into Egypt via the Red Sea, and then run north to the Mediterranean and into Greece or Italy. Both pipelines would require gas to be piped nearly 4,800 kilometers, and cost estimates range from \$20-60 billion. No known feasibility studies exist on either route.

The third possible project would use Iranian gas. In April, Iran reportedly reached an agreement in principle with Turkey to allow construction of a gas pipeline through Turkey which would supply gas to Western Europe. Both would feed off the existing IGAT pipelines which previously supplied the USSR. One pipeline could lead to a Turkish port on the Black Sea, where the gas would be liquefied for shipment across the Mediterranean. Alternatively, the pipeline could cross Turkey, Greece, and Yugoslavia to Italy. Feasibility studies for the pipelines have not been completed.

#### Obstacles

##### Qatar LNG

-- Qatar's perception of low rate of return on the project, in addition to the country's adequate oil reserves, have postponed Qatar's decision on development of the North Dome field.

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-- Possible European and Japanese participants have expressed reservations about the prospective return on their investments and about protection from production cutbacks. The Japanese companies in particular are reported to be pressing for more equity than originally offered by Qatar.

-- Uncertain European and Japanese demand exists for additional gas imports in the 1990's.

-- LNG transport costs (some \$4-5 per MMBTU) are likely to be prohibitive for deliveries to Western Europe.

## Gulf Pipelines

-- It is unlikely that any of the projects could be completed in time to compete effectively with Soviet gas supplies.

-- Costs of at least three to six times that of the Urengoy project to Western Europe would almost certainly be prohibitive and financing would be difficult to impossible to arrange.

-- The political instability and intense rivalries within the region would probably impede implementation of any of the projects and projects might face lengthy delays because of regional strife.

-- Because of large investment and transportation costs, the schemes would likely be unprofitable without substantial European gas price increases.

-- In the case of Iran, the Administration might create a tremendous U.S. political backlash if it championed an Iranian project.

-- Gas supplies would probably face high transit fees, adding to already high pipeline construction costs.

## Possible U.S. Policies

### Qatar LNG

-- The U.S. could ask the Japanese to withdraw from the project, creating additional economic incentives for European companies interested in the project. The Japanese have already lined up a number of potential new supplies and it is possible that they may not need gas from Qatar.

-- We could also "jawbone" the Government of Qatar to the effect that the LNG project is in its economic interest and offers a long-term solution to developing huge North Dome gas reserves.

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Oil as Gas  
Substitute

Oil as an Interim Alternative to Increase Soviet GasDescription

Currently CIA estimates that in 1990 Western Europe will import roughly 11.2 MB/D (oil equivalent) of oil and gas, 37% of its energy supplies. The Yamal Pipeline is perceived in Europe as a mechanism to diversify their risk of vulnerability to supply disruption by reducing oil import reliance and increasing gas import reliance.

	<u>West European Oil/Gas Demand 1990</u>			
	<u>without Yamal</u>		<u>with Yamal</u>	
	<u>MB/D</u>	<u>% Share</u>	<u>MB/D</u>	<u>% Share</u>
Oil Imports	10.0	33.3%	9.5	31.7%
Gas Imports	<u>1.2</u>	<u>4.0%</u>	<u>1.7</u>	<u>5.7%</u>
Total	11.2	37.3	11.2	37.3%
Soviet Gas	0.5	1.7%	1.0	3.3%

One economically viable alternative to the Yamal Pipeline for Western Europe is to use oil imports while developing the North Sea and Norwegian gas resources for delivery in the 1990's. Europe's projected demand for oil and gas have declined significantly since the Yamal Pipeline negotiations began. What appeared to be an extremely tight oil outlook at that time has changed dramatically. Also, gas demand projections have decreased from 6 MB/D (a 1980 forecast by Exxon) to 4.9 MB/D, and some private forecasts are as low as 4.3 MB/D.

DOE now projects that, even under an optimistic 2.8% annual OECD growth rate assumption, OPEC production capacity will exceed demand for OPEC oil by 4.5 MB/D in 1990 (33 MB/D capacity versus 28.5 MB/D demand). Oil prices would rise to \$42.50 per barrel. While there is much uncertainty about future oil prices using oil as a substitute for Yamal gas until North Sea or Norwegian gas can be developed would be more economic. Under this option the U.S. through diplomatic efforts would encourage the development of North Sea and Norwegian gas.

Analysis - Yamal Gas -vs- OilEconomics

In Western Europe, as in the United States, imported oil is the alternative to additional gas supplies, Soviet or otherwise. The marginal market is the industrial/electric utility market, where residual fuel oil is available as an alternative to natural gas. Residual fuel oil prices at the burner tip typically establish a ceiling on gas prices, since industrial consumers can switch to readily available residual oil if gas prices rise above oil prices.

Under present market conditions, Soviet gas prices are above oil prices, if the interest subsidies are included. These raise Soviet prices by 10-15% before correction for the allegedly inflated equipment prices being paid by the Soviets to European vendors.

CIA estimates the border price of Soviet gas to West Germany at \$4.65 per million BTU (1982 U.S. \$). The addition of a \$0.20 distribution and transport charge (based on IEA analysis) yields a \$4.85 per million BTU burner tip delivered price to industrial or utility customers. In May of 1981, the consumer price of residual oil in Western Europe ranged from \$4.60 to \$4.87 per million BTU, but has since declined; spot market prices in Rotterdam (plus an assumed \$0.50/B delivery charge) averaged \$4.71 per million BTU's in the first seven months of 1982, and reached a low of \$4.60 per million BTU's in July. CIA also reports that the gas price is indexed to oil so that future changes in oil prices will be reflected in gas prices.

Thus, Soviet gas will cost the Europeans more than oil when the interest subsidies are considered or above 10% higher than current oil prices and roughly equal to Algerian LNG. Also, European countries will forego the tax revenue resulting from oil use by importing the gas.

### Supply Security

Both imported oil and Soviet gas are risky energy supply sources; either could be cut off in the future due to political developments or military conflict. While we recognize that the Europeans view Soviet gas as less vulnerable to a cutoff it is clear that they are underestimating the downside risks.

Soviet gas supplies appear to offer the apparent advantage of risk-spreading; by substituting Soviet gas for Arab oil (or gas) supplies. Western Europe can reduce the adverse impact of an Arab oil embargo or Middle East conflict, so long as the Soviet Union does not choose to act in concert with the Arab states. However, the risk of a Soviet cutoff in such circumstances would always be present, and highly probable if the Soviets were involved in the conflict.

Western Europe now consumes 430 KB/D (oil equivalent) of Soviet gas. In 1990, this will constitute (estimated) 10% of total gas demand. The Yamal project as now envisioned would raise Soviet market share to 950 KB/D, 25% of estimated gas demand and 3% of total energy. In individual countries the Soviet market share would be even larger--as high as 40% of gas demand in Germany and Italy. Germany has already announced that additional gas storage will be needed to deal with potential interruptions and seasonal changes in demand. Since under the IEA oil stocks already exist at adequate levels increase oil imports would require some additions but may be less costly than gas.

The apparent risk-spreading advantage of Soviet gas is further reduced by the need to invest in capital-intensive gas transport and distribution systems. Even if dual-fuel investments are made by gas users, the economic cost of a cut-off in gas supplies can be very large if it forces discard of extensive capital investment in gas infrastructure. Oil use does not require these investments, and thus is inherently less risky and more flexible.

So long as the Soviets produce the gas now committed to Western Europe, overall energy supplies and OECD energy security will be enhanced. It matters little whether the Soviets export the gas or consume it internally while increasing oil exports. If the Soviets fail to produce the gas, world oil and gas markets may be slightly tighter although projections indicate relatively slack markets through the 1980's.

Thus the apparent risk-spreading advantage of Soviet gas may be marginal or nonexistent particularly in view of decreasing OPEC shares of the world oil market.

In sum, we suspect that the European gas companies are having serious doubts about the marketability of the volumes of the Soviet gas under contract. A well planned alternative involving diplomatic pressure on the United Kingdom and Norway to pursue development of known reserves and a suggestion to West Germany, France, and Italy that the use of oil in the interim could be cheaper may have considerable appearance.

(Prepared by the Office of Management and Budget.)

POLITICAL STRATEGY

### Elements of a European Political Strategy

We should allow the Europeans some time to ruminate on their gas projects with the Soviets in light of their contesting our expanded sanctions. In the interim we should pursue and improve our energy security credibility by moving forward on domestic measures.

Internationally, we should concentrate this summer on analyzing Ambassador Galbraith's findings on the commercial feasibility of various specific energy projects before initiating new effort to seek political commitments from the Europeans.

As a first step, we support Ambassador Galbraith's suggestion that we approach the Dutch to see whether they would increase gas exports in exchange for agreement to replenish Dutch reserves with Norwegian gas in the 1990's. This may require a three-way arrangement among North Sea gas producers. The Dutch, Norwegians and British face the gas strategy question on quite different premises: (A) For the Dutch, the essential question is at what rate and under what conditions gas exports should be phased out; (B) for the Norwegians, the question is essentially at what rate and under what conditions to expand gas exports; (C) for the UK the question is essentially how to encourage greater exploration and production so as to forestall the need to import gas for domestic needs.

Differences in national policy can be anticipated, not only in terms of national gas interests, but also in the assessment of the potential for development of the overall West European gas market. On the commercial side, a small number of exporters gives this market an oligopolistic character. The suppliers have considerable room for intervention to influence long-term market development by giving signals on prices and volumes of supply. Gas has little competition from coal or nuclear power at the present time.

In August we have the opportunity to obtain the views of Ambassador Galbraith and Norwegian State Secretary for Energy, Hans Ramm, on how we might best proceed. If agreed upon by the Buckley Group and Ambassador Galbraith, we should have CIA prepare a sanitized version of its supply/demand analysis for restricted briefings in the fall to select industry/government officials in Europe. We should avoid a high profile inter-agency "mission" approach, given Norwegian and Dutch sensitivities, and coordinate our activities to move in parallel with Ambassador Galbraith's commercial initiative, while the Alternative Energy Group concentrates on energy strategy concerns.



In addition, by fall we can start taking advantage of a number of up-coming bilateral and multilateral meetings to reopen our discussions of alternative energy. After the Dutch have a new Cabinet, explore Dutch willingness to enter into a sequential development arrangement with Norway.

Parallel action, involving ICA, will be needed for publicizing U.S. domestic energy measures and for convincing foreign elites that Europe and Japan have realistic alternatives to reliance on the Soviet Union for energy.

If agreement is reached on a package of measures to facilitate coal exports, Commerce and DOE may wish to sponsor an international coal export conference in cooperation with the U.S. business community. Such a conference would build on the recent Morris coal mission to Europe and the upcoming mission to East Asia.

The Buckley Group meeting with Ambassador Galbraith on August 4 should be used to refine this plan of action. If agreeable to Ambassador Galbraith, he should serve as coordinator for all activities in Europe proposed by U.S. agencies, with support from the Alternative Energy Group.

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## Suggested Scenario

The following scenario integrates proposed domestic and international actions.

### August

#### Domestic

Have the DOE begin to prepare the package that would be used by the President and the Secretary of Energy for announcements and (where appropriate) legislative action in late November.

Develop an announcement for the Secretary of Energy indicating that we intend to study ways to make the market more efficient, to free up supplies for the world market. He, along with the Secretary of Commerce, could announce our intent to create jobs and strengthen the Western economies by studying ways to expand coal exports and increase nuclear's contribution

Announce dates of coal conference, enlist policies/people to maintain dialogue in press on advantages of coal and nuclear as reliable indigenous resources.

#### International

Preparation by CIA of a sanitized version of its supply/demand studies for natural gas.

4 Buckley Group meets and decides on domestic energy initiatives to recommend to the White House for action. U.S. Ambassador to France Evan Galbraith also participates for broad range review of European alternative energy developments. Planning session on further action.

16 Buckley Group meets with Norwegian State Secretary for Energy Hans Henrik Ramm. Ambassador Galbraith to participate. Briefing on CIA study and discussion of our views of Soviet pipeline. Ramm is expected to inform the USG of current Norwegian government plans for gas development.

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September

Domestic

Possible Congressional floor action on proposed coal slurry pipeline legislation.

International

Second IEA Gas Experts Group Meeting, Paris: Possible side meeting on North Sea gas transport options.

Subcabinet Economic consultations with Japan. Opportunity to discuss Japanese assistance to Soviet energy development.

Possible DOE high-level technical mission to Norway.

Alternative Energy Group technical discussions in Europe.

8 Dutch national elections.

October

Domestic

If domestic initiatives on coal agreed upon, and can be announced, international coal export conference sponsored by the Department of Commerce in cooperation with U.S. business community. Announce progress on study of nuclear regulatory reform. Since nuclear nonproliferation discussions with Japan will be well underway, we could hopefully indicate some positive movement to strengthen the regime but at the same time revitalize the industry which could send a positive signal to Europeans. Our posture on nuclear could be vital to the future path the Japanese and Europeans follow in energy usage (i.e., gas or electricity).

International

US-EC semi-annual Consultations in Brussels (tentative). Discussion of energy development alternatives, policy needs and energy security.

OECD/XCSS Meeting: Discussion on the margins.

17-20 Visit by Norwegian King Olav V - probably to include senior ministers.

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26 IEA Governing Board. Informal dinner for US, Norwegian, UK, FRG, and Dutch delegations to discuss alternatives.

November

Domestic

Late November the President could announce that he has directed the Secretary of Energy to prepare and submit to the Hill the legislative package. He should state the aforementioned domestic and international energy security reasons for this action.

International

U.S. Congressional Delegation to the 21st U.S. Congress-European Parliament Exchange in Brussels headed by Congressman Thomas Lantos of California.

Commerce Assistant Secretary Morris leads coal mission to Pacific Rim Countries.

First Sherpas meeting for U.S. Economic Summit in 1983. Opportunity to establish energy security as theme for summit.

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~~SECRET~~Energy Alternatives Update

This paper summarizes reports on energy alternatives developments between July 13 and July 30, 1982.

Norwegian Gas: Oslo 3659 reports that the operators of the Sleipner field, Statoil, Norsk Hydro and Esso, will begin negotiations for the sale of Sleipner gas in August-September. Some 20 potential buyers from the UK, FRG, Netherlands, Belgium, France and Italy have been approached. Gas sales negotiations must be completed before a development plan is submitted to the GON. Both transport options (the Frigg line to Scotland or the Ekofisk line to Emden) will be considered.

In London 15568 the views of Phillips and Mobil are summarized. These firms believe that a variety of UK-sector gas projects will meet growing British demand in the 1980's and 1990's. HMG is said to have "no enthusiasm" for major international projects, however, although all options are open. In London 16283, an Esso executive confirms the Oslo report on Sleipner sales negotiations, but suggests that by 1990 the UK might absorb all of the Sleipner gas for domestic needs and not have any exportable surplus.

Dutch-Belgian Gas Discussions: The Dutch offered to "guarantee" to supply the additional gas Belgium requires in order to forego Soviet gas. The guarantee means the Dutch will supply any gas the Belgians might need through 1995, beyond the supplies already contracted for with Algeria, Norway and the Netherlands (current Dutch contracts will end in 1993).

Any firm commitment on sales terms and volumes is not likely until year-end, however, in view of upcoming Dutch elections and the time required afterwards to form a new government. The Belgians had hoped for more -- a Dutch commitment of gas in such quantities (30-40 bcm) and at a price that would allow them to renegotiate or back-out of their expensive LNG deal with Algeria. Accordingly, in order to strengthen its bargaining position with the Algerians, Belgium will continue to "negotiate" but not conclude any deal with the Soviets for at least six months. (The Hague 5315, 5412, Brussels 9570).

Dutch Gas Policy Re-evaluation: There are more signals that the Netherlands may be moving towards a re-evaluation of its conservationist gas policies. Ambassador Dyess has reported (The Hague 5143) that the question of increased export of Dutch gas is "open, active and sensitive," but that significant political initiatives will not occur until after the September 11 national elections. At the EC Ministerial July 13, Holland informed other European gas

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consumers that it was considering selling more gas. Financial pressures are to some extent driving the Dutch re-evaluation. The need for revenue recently caused the government to order Gasunie to cut prices on gas used in electricity generation, a policy change that will further reduce the volume of gas available for export and affect plans for coal conversion (The Hague 5191, 5315, 5412).

Italy and Algeria: Negotiations on the price for Algerian gas for the trans-Mediterranean pipeline drag on, with little change in the positions of the two parties. In Italy the political constellation remains unchanged, with the Socialists pushing for a deal, and ENI, the Communists and others resisting a settlement that would require heavy state subsidies. Another round of talks is to be held in August (Rome 15967, 17223, Algiers 2846, 3079).

European and Soviet Gas Demand Analyses: A cable from Bonn (Bonn 25968) draws together information from commercial sources and other Embassy reporting to suggest softening gas demand in Europe will not support a "second-strand" pipeline from the USSR.

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Thai Gas for Japan: Following the Thai Government's July 13 decision to allow LNG exports from the large gas field recently discovered in the southern Gulf of Siam, Japanese trading companies are assessing the feasibility of the \$3 billion project. A big question is whether there will be a market for the gas in Japan (Bangkok 42384).

Spain to Withdraw from Soviet Gas Talks: Citing U.S. opposition to the Siberian pipeline and the existence of adequate domestic gas reserves, the Spanish Government has decided to end gas purchase talks with the Soviets. The Spanish have opted to withdraw from these talks as a "concrete gesture to NATO (and particularly the U.S.) of its commitment to the security of Western Europe." The GOS official confirming the policy decision also noted that pipeline delays caused by U.S. sanctions made the gas less attractive, and indicated that Spain calculates it could obtain any additional gas it might need from Algeria (Madrid 7902).

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